Viewpoints on Financial Culture (6)

Incentive and Behavior

Behavior can mostly be explained by there being underlying incentives or motivation, and obviously the behaviors of stakeholders of the financial system shape the culture within. Some stakeholders are more influential than others, notably the financial authorities who define the rules of the game and the financial intermediaries who are in a position to decide where money comes from and where it goes to. Users of financial services, by contrast, do not really have much say; some even do not have the know-how to protect themselves. Yet they are the ones that the financial system is supposed to serve. It may be that open competition among the financial intermediaries in the provision of financial services, under the watchful eyes of the financial authorities, would still mean that they are generally well served. But experience tells us that this is far from being the case. The problem is very much a cultural one, with wrong incentives shaping questionable behaviors.

As discussed in earlier Viewpoints in this series, in, for example, facilitating the transaction of risks in secondary markets, or market making, there are many opportunities for financial intermediaries to make quick money, possibly in large amounts. This is particularly so when market prices, for one reason or another, are volatile. I can still remember the rather revealing comment by a stock broker made during the Sino-British negotiations on the future of Hong Kong before the reversion of sovereignty in 1997. Then the catchphrase of the negotiations was to maintain the "stability and prosperity" of Hong Kong. This rather senior stock broker said in a rather fact of the matter manner that "in finance, there is no prosperity with stability; prosperity only comes with instability". He rolled his eyes backward contemptuously when I, as a junior public officer in money and finance, responded by reminding him about the role of the market in efficient price discovery and the fundamentally important function of the secondary market in the provision of liquidity that encourages the mobilization of money through the primary market.

Thus, it is in the interest of market makers that there is market volatility, or "vol", as they call it with considerable professional flair. They hate it if there is no "vol" in the market, obviously because of the lack of opportunity in a well-functioning and stable market in making money. Looking first at the level of individuals employed by financial intermediaries, it is not difficult to appreciate the mentality of many a trader when he or she arrives at his or her desk in whatever hour of his or her working day. There are position limits, intraday as well as end-of-day, that he is required to observe, as part of the risk management parameters laid down by the firm. He is given a mandate that has much emphasis on revenue generation, although there are these other requirements of compliance, risk management, etc. And he is remunerated largely, or in some cases solely, on how well he does in revenue generation (in other words, his contribution to profits made by the firm), in the form of variable pay, the amount of which pales his pitiful little amount of fixed pay in comparison. He loves "vol"; probably his next vacation, sports car, and mortgage payment for his decent home depend on it. How do you expect a young and money hungry trader, probably in his late twenties, would behave, working within this type of incentive structure?

To be fair, probably the great majority would not venture into what is now receiving sharp attention and, by both the financial regulators and those being regulated, called misconduct. After all, there are codes of conduct and other rule books (regulatory, industry as well as firm-specific) to be observed, and Big Brother is always watching through an elaborate system of monitoring and surveillance. But it is a matter of fact that a small minority of front-line traders have engaged in outright misconduct of different kinds, and it would be hard to argue that the main motivation for doing so did not come from the incentive structure. In the moneymaking game of trading, being the star trader of the firm or the industry is of course attractive, and young traders do have a bigger ego than perhaps employees of other professions; but it is hard to attribute misconduct more to ego than to monetary incentives. Indeed, a trader recently testifying in court in relation to a financial market manipulation case said: “I wanted every bit of money I could get because that’s your performance metric, that’s how you’re judged.”

Various types of misconduct by front-line traders have been identified in a number of high-profile cases in recent years in developed markets. Unauthorized trading is one; perhaps the traders were hoping that making big money for the firm while breaching limits or hiding the breaching of limits would be tolerated. Manipulating the fixing of benchmark prices, such as those for interbank money market rates and exchange rates, is another, perhaps hoping that such manipulation would help to show greater profits attributable to them (or their teammates) in the relevant books of the firm, thus choosing to ignore that the fundamental role of benchmarking is to facilitate accurate price discovery. Cheating customers on what the prevailing price is in markets to which the firm has privileged access is yet another, perhaps hoping to profit the additional few “pips” when the unknowing customers deal with the firm at marked-up prices, away from market prices that are considered to be fair even after including a reasonable “spread” to pay for the service.

Misconduct is, regrettably, not just limited to front-line traders. In different interactions with customers of financial institutions, there is always scope and therefore the temptation for employees to put the interest of the financial institutions and therefore of themselves on top of the interests of customers. It is often difficult to prove that such misconduct has taken place; so as long as the incentive (greater profits translating into bigger bonuses) for doing so is there, resisting such temptation takes unusual (and possibly unnatural in the minds of some employees) discipline. One therefore hears of such cases (in investment banking, private banking, wealth management, asset management, and other activities in financial institutions) being recognized very much as an unavoidable, rather than unacceptable, phenomenon. Identified cases are, I am sure, dealt with expeditiously in all financial institutions and remediation of the relevant monitoring and surveillance systems introduced. But I am also quite sure that there are unidentified ones, possibly in greater numbers. And the sanctions imposed on the identified cases seem inadequate to produce a meaningful deterrent effect.

Individual misconduct is, I would like to believe, not prevalent in the industry; but it was revealing to read in recent press reports on manipulation in the foreign exchange market what a trader had said about the industry norm, which was something to the effect that "if you are not cheating, then you are not trying hard enough." The responses of the authorities—the law enforcement agencies and the regulators—have been the imposition of big fines in billions for the financial intermediaries and criminalization, both at the firm and individual levels, as well as much tighter and more intrusive regulatory requirements. The responses of the financial intermediaries have largely been to strengthen monitoring and surveillance and to place much greater emphasis on compliance, in other words, an expensive and expansive role for Big Brother, and promoting much greater awareness on the front line that Big Brother is watching you. While these responses are obviously considered necessary by those concerned, differences of opinion between the authorities and the industry notwithstanding, no one seems to care about how the billions of big fines and remediation expenses spent on sharpening the eyes of Big Brother would be paid for. Sadly they would all be absorbed as part of the cost of financial intermediation, charged by the financial intermediaries and involuntarily paid for by users of financial services, thus implying lower efficiency of financial intermediation in the economy.

On a more encouraging note, a noticeable but not (yet) mainstream response has interestingly been attempts to introduce a rather more fundamental change of culture to place much greater emphasis than before on serving well users of financial services. Whether this renewed recognition by selected financial intermediaries of the purpose of their existence, which is protected by licenses giving them privileged access to financial markets, will intensify in the industry to the extent of leading to a lesser role for both the regulators and Big Brother, and thus greater efficiency in financial intermediation, remains to be seen. At the level of individual traders, the change of culture should help to reduce or eliminate individual misconduct. But in my opinion this has to be supported by the removal of the incentives for misconduct embedded in current compensation arrangements in the industry.

At the firm level, the private interest in profit maximization, working through basically a similar incentive structure for management, as individuals, predominates. There is great emphasis on enhancing shareholders' value, as reflected in the sharp focus of shareholders, investors, analysts, and management on the share price of the firm, if it is a listed one, and a host of other measures on profitability. When the largest component of the remuneration of management is variable and awarded mainly by reference to different measures of profitability and largely takes the form of stocks of the firm, deferrals and selling restrictions notwithstanding, the private interest of management is aligned with that of shareholders. Understandably, therefore, profit maximization is of overriding importance in the management of financial intermediaries, over such other desirable objectives as customer satisfaction at the micro level and efficient financial intermediation that serves well the economy at the macro level. And so, when financial intermediaries are left very much on their own to run their businesses, the resulting balance struck between the conflicting interests in finance has always been in favor of the private interest of the financial intermediaries, and excessively so.

This incentive structure at the management level of financial intermediaries has shaped institutional behaviors that are a lot more complex. A questionable practice that comes to mind immediately is proprietary trading. Financial intermediaries have a captive and therefore privileged access to certain financial markets. As such, they are better positioned to identify short- or longer-term market trends ahead of those without privileged access, importantly the great majority of users of financial services who have to trade through them. The temptation of deploying this "expertise", or privileged information from clients, for the benefit of the firm by taking proprietary market positions and funding them with depositors' and clients' money, or money raised through other forms of borrowing, for the purpose of profit maximization, is clearly there. To me, the principal objection here is insider trading. And even if the trading is organized independent of any interface with clients, the objection is the engagement in playing a zero-sum game and expecting to win persistently.

Some would say that proprietary trading is now history, or soon to be, given the implementation of the famous Volcker Rule, now enshrined in the Dodd-Frank Act of the United States, assuming that President Trump will have difficulty in repealing it. US legislation, particularly financial legislation, has extraterritorial application, given political reality, the extensive use of the US dollar in international finance, and the ultimate clearing of US dollar denominated transactions in the US. In any case, even though the long reach of US laws is unwelcomed, it is likely that the spirit of the Volcker Rule will similarly be enshrined in the domestic legislation of other jurisdictions, particularly those who are the homes or hosts of internationally active financial intermediaries. Indeed, one hopes that this initiative will mean the end of proprietary trading, and there will no longer be any punting of depositors' money in exotic financial instruments promising high yields and low risks. But I fear that the jury is still out. Under the framework of the Dodd-Frank Act, there are key exemptions allowed for the taking of proprietary positions, very much the result of a political process in which the views of politically influential Wall Street had to be accommodated. One should simply not underestimate the ability of the financial intermediaries subject to the relevant prohibitions on proprietary trading to make imaginative use of the exemptions allowed. They do not need encouragement from President Trump!

For as long as there are financial markets, there have been various forms of proprietary trading by the financial intermediaries. And many have reported handsome trading profits in whatever financial instruments and in making use of whatever complex trading models in vogue at the time and awarded astronomical bonuses. Who paid for them? Collectively, it would be the users of financial services—the losers in the zero-sum game—perhaps unknowingly. Occasionally but hopefully not too often, they would be paid from the public purse when, by being "too big to fail", financial intermediaries had to be rescued by governments when things developed into crisis dimensions. Alternatively, they would be paid by the shareholders (also users of financial services) when losses, or worse still bankruptcy, eventually materialize (for example, proprietary positions in subprime CDOs), or when misconduct is eventually revealed and hefty fines (some politically inspired) are imposed by the authorities. The irony of all this is that, in the great majority of cases, those responsible for the mess have already had their bonuses put safely away to support their luxurious life styles forever, whether or not the financial crisis has also swept their lucrative jobs away. A few have, however, ended up in jail when misconduct was found to have crossed the threshold of criminality.

Even with prohibitions on proprietary trading, articulating a case, for the consumption of whoever that needs to be convinced, that certain trading activities are necessary for underwriting and market making related activities, or for risk mitigating hedging, thus falling within the key exemptions also allowed, is not such a difficult task. So is demonstrating that those trading activities do not involve any transactions that would result in a "material conflict of interest" with a customer. The attractiveness of making quick profits by taking and closing a position in a particular financial product, or in a relevant (or correlated) liquid market is always there in front of financial intermediaries. As long as there is a reasonable explanation or excuse, the risk is taken. Typical is the use of the infamous Credit Default Swaps (CDS) for the management of credit risks or market risks that were taken earlier against risk management parameters that are now considered inadequate in the light of changed market sentiment. Regulators obviously would not wish to challenge financial intermediaries when they "prudently" take the view that additional hedges have become necessary in managing whatever risks the firm is exposed to. Readers can perhaps appreciate better the difficulties in judging whether proprietary trading is involved when, for example, a financial intermediary takes action to short the equity market as a whole, through using exchange-traded equity derivatives, to arrange for "additional" hedge against idiosyncratic credit risks associated with margin lending collateralized, say, 50% on particular stocks, when the stock market looks, from the eyes of the experts, like “gapping” down. And there is now still an accepted industry practice of “pre-positioning” the firm to cope with known or anticipated demands for market making, apparently in order to serve customers better, when arguably this is front-running.

I fear that there is much of this questionable type of market making or risk mitigating hedging that goes on within financial intermediaries. This is disguised proprietary trading to get around prohibitions, where they exist or apply. Yes, lessons have been learnt from the subprime crisis, and rules and regulations have been put in place to prevent recurrence, but ways will be or have already been found to get around them. The incentive arrangements in the financial system are sustaining a culture that puts disproportionate emphasis on profit and bonus maximization over the better performance of the fundamental role of serving the economy. And the culture encourages, among other things, a continued desire to play and win that zero-sum game, involving much effort in developing what Alan Greenspan with an endorsing tone calls “cutting-edge” finance (and in compliance and risk management). The complexity of financial arrangements invented and business models pursued, sooner or later, exposes financial institutions to unknown, unquantified, and therefore unmanaged risks, and unknowingly creates systemic risks of a crisis dimension. This obviously is not what the respectable Mr. Volcker and Mr. Greenspan want. The authorities with responsibility over the financial system can legitimately question and rule, moral hazard notwithstanding, whether a specific cutting-edge financial arrangement is necessary in order that the financial system can better serve the economy. They can also question, as they are already doing, whether Big Brother is big enough for managing the known or unknown risks, while continuing to respect private sector initiatives. But the real issue is culture.

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