

Viewpoints on Financial Culture (8)

Inter-Temporal Shift of the Intermediation Spread

The important services provided by the financial system in mobilizing money from those who have it to those in need of it obviously are not free. There are costs involved in the provision of the many different types of financial services—the operating costs of financial institutions, including overheads, salaries and profits, and the commissions and fees charged, etc. Fines and litigation expenses are also part of the costs, so are the expansive and expensive systems of compliance, monitoring, and surveillance now typical of complex financial institutions. There are also those costs represented by the relevant government or industry levies, whether or not they are for the purpose of funding the regulation of financial markets and the supervision of financial institutions. The list goes on. These costs obviously have to be paid for predominantly by users of financial services, in the form of those having money accepting a lower rate of return for their money and those raising money accepting a higher funding cost than would otherwise be the case. From a macro perspective, the totality of these costs can be referred to as the intermediation spread (IS) charged by the financial system for performing the important function of financial intermediation.

I am not aware of serious attempts in any jurisdiction to measure the intermediation spread in the domestic financial system. Perhaps this is a reflection of the general lack of focus, on the part of the financial authorities or financial research in organizing their work, in promoting the public interest in finance. Intuitively, it can be said that the smaller the intermediation spread in finance in an economy, the higher the efficiency of the financial system, and this is obviously in the public interest. But I would not underestimate the difficulty in coming up with a meaningful measure to help in policy-making in finance, particularly when under globalization financial intermediaries operate on an international basis. Using Hong Kong as an example, given its status as an international financial centre, the intermediation spread earned by financial intermediaries in Hong Kong, whether in absolute or in

percentage terms, cannot be used as an indication of efficiency of the financial system of Hong Kong in mobilizing money in Hong Kong. Indeed, the larger the intermediation spread earned in Hong Kong, the more successful is Hong Kong in the mobilization of money between the Mainland and the rest of the world, which is its main role as the international financial centre of China.

But I would argue that it is necessary, in promoting the public interest in finance, to pay much greater attention to the intermediation spread, in measuring it and in monitoring its movements over time. I would like to distinguish between two possible approaches—one from the providers' point of view, IS(P), and the other from the users' point of view, IS(U).

- A comprehensive measure of IS(P) would simply be the total income of the financial intermediaries, whether they are banks, investment banks, brokers, or fund managers. We can also throw in the income (assuming all costs, plus profits, are recovered by charges levied on users with no subsidies) of financial institutions providing trading, settlement, clearing, custodian, and related services. There are less comprehensive measures, such as the net interest margin (NIM) of banks, profitability of financial intermediaries, or compensation levels of employees in finance, that can serve as useful indicators of the movement of the various components of IS(P) over time.
- IS(U) conceptually is the difference between the average rate of return achieved in the many different types of investments available to those with money and the average cost of funds for those raising money, such as the lending interest rates charged by banks, interest rates of debt issues, etc. Again, coming up with a comprehensive and reliable measure of IS(U) is probably difficult, but movements of less comprehensive measures, such as stock market indexes and various benchmark interest rates, over time can be used as indicators of the movement of the various components.

The two approaches to measuring the intermediation spread should produce the same quantitative result, kind of like the income and production approaches in the measurement of gross domestic product. This must intuitively be the case in the long run, although such short-term factors as the monetary policy stance and performance of the economy can be expected to impact stakeholders of the financial system differently so as to lead to statistical differences between the two measures and produce divergent short-term trends. Take, for example, a time at which there is a move towards monetary tightening. Users of financial services, with the exception of depositors who are not borrowing money, may take a double-barreled hit in terms of suffering a downward adjustment in the prices of financial assets induced by prospects of hikes in policy interest rates and higher funding costs, in other words, a widening of IS(U). This may not necessarily be instantaneously matched by an increase in the total income of the financial intermediaries to the same extent. Through reducing the availability and increasing the price of credit, and therefore negatively affecting lending business, the short-term impact on IS(P) of a move of the monetary policy stance towards tightening could well be to narrow it, so is the case of the expected reallocation of financial resources by investors from capital market instruments to deposits, induced by higher policy interest rates.

While short-term divergence between IS(P) and IS(U) can be expected as a result of policy shocks impacting different stakeholders differently, in the medium to long term they should be the same, as simply they are different ways of looking at or measuring the same thing. So what should be of concern to all is if there is a substantial and sustained divergence between them. Take, for example, a period in which IS(P), for whatever reasons, persistently stays at a much higher level above IS(U). This, some would argue, would be a phenomenon to be welcomed, as a high IS(P) indicates that the financial intermediaries are doing good business, making large profits and those employed there earning large bonuses, and a low IS(U) indicates that investors are getting high rates of return for their money and fund raisers are raising money cheaply. But this is precisely when all stakeholders, particularly those responsible for protecting the public interest in finance, should get concerned because

payback time is on its way. The long-term quantitative identity between IS(P) and IS(U) requires a reversal of the two. Chances are that IS(U) would go sharply higher over a short period, when investors would lose much money and fund raisers would have to pay much to raise money, if money is available at all, in other words, the reversal occurs in the context of a debilitating financial crisis. The phenomenon of IS(P) persistently staying much above IS(U) presages an oncoming financial crisis!

Although there are no comprehensive measures that I can rely on, anecdotal evidence suggests the following behavior of IS(P) and IS(U) over time. Very much the result of the questionable culture in finance, which is reinforced by the politics in finance, IS(P) has been sustained at a high and possibly increasing level over a long period of time. Even in times of financial crisis, when the profitability of financial intermediaries has been adversely affected, the costs in the provision of financial services remained high. Efforts to reduce operating costs were offset by increases in compliance costs arising from regulatory tightening by the authorities and the hefty fines imposed by law enforcement agencies on misconduct of the past. Only a limited number of financial intermediaries went out of business; those that were too big to fail were considered systemically important and were rescued with public money. And so the finance industry and therefore IS(P) did not really shrink that much over the financial crisis. IS(U), on the other hand, has demonstrated a much less stable behavior, characterized by a recurring longish declining trend followed by a very sharp hike occurring in the context of a financial crisis, when investors lost a lot of money and funding became very costly and even dried up, creating much economic hardship for users of financial services. There is thus a tendency in finance for there to be an inter-temporal shift in the intermediation spread (ISIS!). In other words, IS(U) in the future is being shifted to the present to sustain a high IS(P) much above IS(U).

At the risk of belaboring the point, let us look back at roughly the decade in between the two financial crises of 1997 and 2008. We saw attractive returns from financial assets combined with an abundance of cheap money for borrowers,

suggesting a small IS(U), which was possibly also declining, given the economic characteristics and the general monetary policy stance during the decade. Indeed, notwithstanding fairly low deposit interest rates, investors were getting much higher rates of return from a rich supply of investment products that appeared to be of low risk as well, for example, triple-A rated collateralized debt obligations (CDO), which were marketed worldwide at the retail level, not least in Hong Kong in the form of mini-bonds. Borrowers were getting cheap money in abundance. Even those not creditworthy were given or lured into borrowing cheap money, for example, 100% loan-to-value mortgages to households in the US, who could barely meet their mortgage payments. Yet, at the same time, financial intermediaries were experiencing a golden period of high incomes, and therefore high profitability and astronomical compensation, in other words, a large and possibly increasing IS(P) over the period.

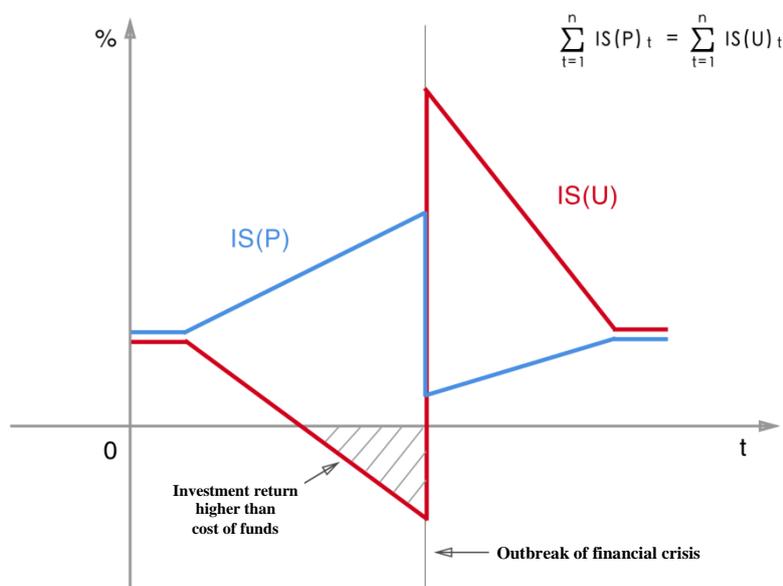
Not a lot of attention was paid to explaining this anomaly between IS(U) and IS(P), as everybody seemed to be enjoying themselves in a golden age of high investment returns and cheap money for users of financial services, and huge profitability and compensation for financial intermediaries. Where concerns were expressed, for example, over the sustainability of certain business models of financial intermediaries, these were overwhelmed by the loud praises on the ingenuity that was driving financial innovation and the supremacy of market freedom in the allocation of financial resources. The possibility that the anomaly could be an indicator of risks not identified, understood, and prudently managed, and of a systemic nature, being created in the financial system, was simply overlooked.

We all know how this ended. In terms of the intermediation spread, we observed the following phenomenon during the crisis. Investors, including shareholders of financial institutions, lost a lot of money, giving back much of the high return they had been enjoying. Funding became very costly and even dried up for borrowers, creating much economic hardship, including bankruptcy. Users of financial services suffered, in other words, there was a very sharp widening of IS(U) in the financial

crisis. Profitability of the financial intermediaries collapsed and compensation of employees was cut, but to a much lesser extent, as the culprits simply switched jobs and employers, and also switched roles, for example, from being a punter of depositors' money in running proprietary positions in one financial institution to being responsible for sorting out the mess in another financial institution. IS(P), nevertheless, fell, at least for a while. Thus the anomaly that appeared in the earlier “golden” period was eventually reversed in the context of a financial crisis, in other words, an inter-temporal shift of the intermediation spread occurred.

Putting all this bluntly, the culture of modern-day finance gives the financial intermediaries an ability to steal from future users of financial services!

Inter-Temporal Shift of the Intermediation Spread



Joseph Yam

17 July 2017