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The Great Bank Robbery

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For the American economy – and for many other developed economies – the elephant in the room is the amount of money paid to bankers over the last five years. In the United States, the sum stands at an astounding $2.2 trillion for banks that have filings with the US Securities and Exchange Commission. Extrapolating over the coming decade, the numbers would approach $5 trillion, an amount vastly larger than what both President Barack Obama’s administration and his Republican opponents seem willing to cut from further government deficits.

That $5 trillion dollars is not money invested in building roads, schools, and other long-term projects, but is directly transferred from the American economy to the personal accounts of bank executives and employees. Such transfers represent as cunning a tax on everyone else as one can imagine. It feels quite iniquitous that bankers, having helped cause today’s financial and economic troubles, are the only class that is not suffering from them – and in many cases are actually benefiting.

Mainstream megabanks are puzzling in many respects. It is (now) no secret that they have operated so far as large sophisticated compensation schemes, masking probabilities of low-risk, high-impact “Black Swan” events and benefiting from the free backstop of implicit public guarantees. Excessive leverage, rather than skills, can be seen as the source of their resulting profits, which then flow disproportionately to employees, and of their sometimes-massive losses, which are borne by shareholders and taxpayers.

In other words, banks take risks, get paid for the upside, and then transfer the downside to shareholders, taxpayers, and even retirees. In order to rescue the banking system, the Federal Reserve, for example, put interest rates at artificially low levels; as was disclosed recently, it also has provided secret loans of $1.2 trillion to banks. The main effect so far has been to help bankers generate bonuses (rather than attract borrowers) by hiding exposures.

Taxpayers end up paying for these exposures, as do retirees and others who rely on returns from their savings. Moreover, low-interest-rate policies transfer inflation risk to all savers – and to future generations. Perhaps the greatest insult to taxpayers, then, is that bankers' compensation last year was back at its pre-crisis level.

Of course, before being bailed out by governments, banks had never made any return in their history, assuming that their assets are properly marked to market. Nor should they produce any return in the long run, as their business model remains identical to what it was before, with only cosmetic modifications concerning trading risks.

So the facts are clear. But, as individual taxpayers, we are helpless, because we do not control outcomes, owing to the concerted efforts of lobbyists, or, worse, economic policymakers. Our subsidizing of bank managers and executives is completely involuntary.

But the puzzle represents an even bigger elephant. Why does any investment manager buy the stocks of banks that pay out very large portions of their earnings to their employees?

The promise of replicating past returns cannot be the reason, given the inadequacy of those returns. In fact, filtering out stocks in accordance with payouts would have lowered the draw-downs on investment in the financial sector by well over half over the past 20 years, with no loss in returns.

Why do portfolio and pension-fund managers hope to receive impunity from their investors? Isn't it obvious to investors that they are voluntarily transferring their clients' funds to the pockets of bankers? Aren't fund managers violating both fiduciary responsibilities and moral rules? Are they missing the only opportunity we have to discipline the banks and force them to compete for responsible risk-taking?

It is hard to understand why the market mechanism does not eliminate such questions. A well-functioning market would produce outcomes that favor banks with the right exposures, the right compensation schemes, the right risk-sharing, and therefore the right corporate governance.

One may wonder: If investment managers and their clients don't receive high returns on bank stocks, as they would if they were profiting from bankers' externalization of risk onto taxpayers, why do they hold them at all? The answer is the so-called "beta": banks represent a large share of the S&P 500, and managers need to be invested in them.

We don't believe that regulation is a panacea for this state of affairs. The largest, most sophisticated banks have become expert at remaining one step ahead of regulators – constantly creating complex financial products and derivatives that skirt the letter of the rules. In these circumstances, more complicated regulations merely mean more billable hours for lawyers, more income for regulators switching sides, and more profits for derivatives traders.

Investment managers have a moral and professional responsibility to play their role in bringing some discipline into the banking system. Their first step should be to separate banks according to their compensation criteria.

Investors have used ethical grounds in the past – excluding, say, tobacco companies or corporations abetting apartheid in South Africa – and have been successful in generating pressure on the underlying stocks. Investing in banks constitutes a double breach – ethical and professional. Investors, and the rest of us, would be much better off if these funds flowed to more productive companies, perhaps with an amount equivalent to what would be transferred to bankers' bonuses redirected to well-managed charities.

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