COINING IT IN
HOW COMPANIES ARE HOPING THAT IT’S BUSINESS AS USUAL
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How companies are hoping that it’s business as usual

1 Introduction

Despite the global financial crisis, despite phenomenal quantities of public money being needed to keep the financial system afloat, despite many of the world’s economies being plunged into recession as a consequence, the men in charge of the world’s major companies (they are, almost without exception, men) are continuing to enjoy their pay and rewards. Executive pay is rocketing.

How is it possible? It is possible because executive pay and bonuses are linked with company performance or, in other words, with how much profit gets made. And the real scandal – a bigger scandal even than the bloated size of executives’ pay – is that these profits are continuing to be turned in at grossly excessive levels.

Ordinary people are paying the costs of the crisis. Companies, and their investors, are still enjoying good times.

This report looks beyond the bonus into how business is setting unrealistic targets for corporate returns, the pursuit of which triggers false expectations, erroneous behaviour, threats to investment and ‘forced’ pressure to reduce labour costs. The policy of setting unrealistic rates of return on equity spilled over into the rest of the economy from the finance sector. This policy is unsustainable.
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Taking a lead from the banks

We’ll begin by considering the banks.

It was the banks which drove the world headlong into the financial crisis of 2007-8. So – even if other sectors are able to maintain high profits in the present difficult times – you might think that the banks would have to make do now with much less.

You’d be wrong. As we’ll see, banks are trying to ensure that the returns for their investors are getting back towards the very high level of returns they were getting before 2007-8.

The story of how banks are defending their levels of returns is important in its own right. But it is also significant for other sectors of the economy, for the banking sector has tended in recent times to act as the leader of the pack. In other words, if investors in banks are continuing to enjoy high rewards, then naturally investors in every other sector expect to do likewise. Banks are still, to a large extent, creating the culture of excess.

And there is another reason why the banking sector deserves special attention – it is because it can achieve high returns as a direct consequence of the fact that it enjoys a hidden subsidy from us all.

3

How the banks measure how well they’re doing

Banks\(^1\) conventionally use one key indicator to measure their performance, the return on equity (ROE). Return on equity is the annual net income which a bank receives as a percentage of the total amount of the equity (shareholder capital).

For a quarter of a century after the second world war, banks’ ROE – averaged out – tended to trot along somewhere around the 8% mark. In this respect it was in line with the sort of performance which other businesses aimed to achieve.

But then, sometime from 1970 onwards, something changed. The ROE with which banks were rewarding their shareholders ballooned. ROEs crept ever upwards. Up to 15%; up to 20%; and beyond. It has not been entirely a story of constant growth, but the trend is clear.

The graph below shows ROE for British financial institutions. A similar picture applies for other countries with major banking sectors.

\(^1\) The term ‘bank’ in this report is taken to mean publicly quoted share companies. Some countries also have a significant cooperative banking sector. Cooperative banks are owned by their members, not by shareholders, and this report isn’t applicable to them.
There are various ways in which, if you are a senior banker, you can try to improve your company's ROE. You can aim to improve productivity, making your workers work harder or more efficiently, for example. You can increase the spread (the difference in interest) between the money you take in and the money you lend out.

But steps like these will only achieve so much. The key to achieving dramatic increases in ROE is simple. It is to borrow. It is to take more and more debt on to your balance sheet, so that proportionately the equity capital becomes an ever smaller part of your overall funds. This is called leveraging, and banks over the past twenty or thirty years have leveraged like crazy.

It works a treat, as a simple example demonstrates. Let's say you run your own home bank which (probably illegally) lends money to your neighbours. You start with $1000 of your own money and lend it to the folk next door, at 5%. Not bad, you'll earn $50 in interest a year. Your brothers and sisters and uncles and aunts are impressed by your acumen (and your business suit) so you persuade them to lend you a further $5000, paying them 3%. Now you're able to make five other $1000 loans to other neighbours and to earn in total $300 in interest. Take away the interest you owe your family, and you'll end up netting $150 rather than $50. You've leveraged your original $1000 capital up to $6000, on a 5:1 debt/equity ratio, and in so doing your profits have magically trebled. Your return on equity has grown from 5% to 15%.

This is basically the secret of retail banking.

However, any decent bank would sneer at a 5:1 debt/equity ratio. During the course of the twentieth century, leverage increased from around four times equity to twenty times equity. It then hit thirty or more, even in some banks reaching 50 at the peak of the boom. It was so simple: the more you leveraged in debt capital, the more your ROE improved.

The European Central Bank has reproduced the following table from Bloomberg, showing leverage in six major international banks in the years from 2003 to 2007.
Side-stepping the risk

There is one obvious drawback if you are a bank in taking on ever-increasing quantities of debt, and that is that you are increasing your risk. More precisely, you are increasing the risk for your shareholders, who potentially could see the value of their investments fall if the loans you've made go belly-up or if your creditors unexpectedly want their money back.

Fortunately for the shareholders, most banks have had limited liability for a century or more, so their potential loss is limited to what they originally put in. And, even more fortunately – as the crisis of 2007-8 reminded us – the larger banks pass on this risk to the rest of us. Banks are essential to the smooth operating of the economy, and of society. That's why governments were obliged to step in with eye-watering amounts of money to bail them out. These were banks which were too big to fail – TBTF, in the jargon.

So bank shareholders have had a charmed life. They have been able to enjoy the upside, whilst being able to cap their downside at zero. The profits have been privatised, the risks are socialised.

And senior bank staff, whose pay as we've seen is linked to performance, have had a charmed life too.

But then came the crash

But then came the crash, and everything changed.
Banks realised the error of their past ways, and understood that the returns on equity they had been obtaining were quite unsustainable.

...Or perhaps not.

Let's consider the following press cuttings:

“Deutsche Bank CEO Juergen Fitschen says the bank is planning a 15% return-on-equity” (Dec 6 2011)

“Botin [Emilio Botin, Chairman, Santander] reiterated a target for Santander to achieve return on equity of 12 percent to 14 percent in 2014” (31 Jan 2012)

“Société Générale is now aiming for a return on equity of between 12 percent and 15 percent.” (3 August 2011)

“Goldman Sachs estimates that return on equity in this year's first quarter was about 16%, below management’s cross-cycle return on equity target of 20%” (12 May 2011)

“HSBC said yesterday it will target a return on equity of 12 percent to 15 percent... Return on equity of about 18 percent to 20 percent 'is achievable’ for HSBC in Asia.” (28 Feb 2011)

“[Credit Suisse] has 14.4 percent ROE in 2010” (10 Feb 2011)


Another chart from the European Central Bank looks at performance from twelve international banks from 2003-2010. It shows ROE growing from an average of around 15%-18% in 2003 up to 25% in 2007, immediately before the crash. (The shaded area, the interquartile range, represents the middle 50% of the banks sampled). ROE certainly fell immediately after 2007, but is now climbing again. The top of the shaded area is well over 15% - which tells us that all the top quartile, a quarter of the banks sampled, were bringing in ROEs above 15% in this period.

So let’s summarise. At the time when much of the developed world is in the depths of an economic recession, when unemployment, particularly youth unemployment, is at levels which in many countries threaten social cohesion, when there is a sovereign debt crisis in the Euro zone which governments are struggling to overcome and when public spending is being slashed, at the same time our major banks are still looking to reward
shareholders with ROEs which are climbing back to pre 2007 levels. Even those banks which were bailed out (such as Lloyds Banking group, which is majority owned by the UK taxpayer) are in on the act.

There is one simple explanation, of course: banks are so valuable in the work they do for the rest of us that they are worth it.

6
Because they’re worth it?

Curiously, though, not everyone seems to buy this argument.

The issue of bank ROE was addressed head-on by the economist and Financial Times writer Martin Wolf in a blog in September 2010. A few quotes give a sense of his argument:

According to a FT article last week, Lloyds’ bank has a target return on equity of 14.5 per cent. Banks like to argue that this is the level of return on equity they need to earn, in order to gain funding from the markets. Naturally, remuneration is linked to achieving such objectives. The question, however, is whether such objectives make any sense. The brief answer is: no.

...It is perfectly obvious that these cannot be sustainable safe returns in economies growing at 2 per cent a year, for such a large and well-established industry. At a 15 per cent real return, the value of cumulative retained earnings would double in five years and increase 16-fold in 20 years. Pretty soon, bank equity would be the only real asset in the world!

This last sentence, Martin Wolf had subsequently to explain to a confused respondent to his blog, was meant to be taken satirically! Satire may be the only tool left, though, when trying to explain something apparently inexplicable: how do you get such high returns in an economic recession?

Wolf offers three explanations: the first is that banks, by continuing to operate with highly leveraged balance sheets, are still engaging in extreme risk-taking. Secondly, they are enjoying monopoly profits (it’s not easy to start a new bank). And thirdly, they are benefiting from implicit government guarantees. As he writes:

In short, when banks tell us that 15 per cent (or something in that neighbourhood) is their target returns on equity, they are saying that their businesses are very risky and/or protected against competition and/or well subsidised and probably a bit of all three.
So where does the idea that an ROE of, say, 15% is ‘normal’ for a bank? The banks themselves like to suggest that this is something outside their control – it is ‘the markets’ which are insisting on it.

This was the implicit message, for example, in the report from the Institute of International Finance in September 2011 on banking regulatory change. The IIF report is, in a very roundabout way, trying to warn the international banking regulators to cool it. Too much regulation will harm bank lending and therefore the economy, it claims: “If equity investors were willing to supply more bank equity at a lower cost (reflecting greater security) and bank bond investors were equally prepared to supply more long-term debt at manageable spreads, then the negative growth implications of the capital and liquidity reforms could turn out to be modest.” But no, sadly, this seems unlikely. The report continues: “So far, however, capital markets in bank funding instruments are tending to do the opposite”. The vision comes to mind of a room full of bankers wringing their hands.

It perhaps doesn’t help that some parts of the bank regulatory machinery have appeared implicitly to accept an ROE target of around 15% for the banks. This was the basis, for example, on which the Basel Committee on Banking Supervision calculated the likely long-term effects of the proposed tighter capital and liquidity requirements in their August 2010 report. (Why did the Basel Committee choose 15%? Why not, as the organisation Americans for Financial Reform put it subsequently in their submission to the Basel Committee, calculate it on 10% instead, “a level that is still somewhat higher than the overall level of return in the economy”)?

All of which leads to an interesting question: just what is it that banks do for the economy? Just how much wealth do they create?

Since the 2007-8 crash this has been a debated issue among some economists. It is normally relatively straightforward to measure the value added by an industry or business. If I make furniture, say, the value I add is the difference between the inputs I need for my business (wood, equipment, labour costs and so on) and the price I get when I sell the finished pieces to my customers. My expertise and the capital I’ve used, together with the skills and efforts of my workers, have created more than the sum of the parts – I’ve created wealth.

With banks, it’s much more opaque, since they often do not charge explicitly for their services.

Banks perform various functions, including bringing together would-be borrowers and would-be savers (‘financial intermediation’), providing payment services, delivering a market-making role (such as in foreign exchange or commodities) and taking on risk from others. There are functions here which certainly are value-creating.

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2 The IIF is chaired by the Chairman of Deutsche Bank, its vice-chairmen are Presidents and/or CEOs of Unibanco, BBVA, Scotiabank, and SEB, and its directors include the top guys in, for example, Commerzbank, Morgan Stanley, Goldman Sachs, Citigroup, Société Générale, Standard Chartered, BNY Mellon, Crédit Suisse, BNP Paribas, JP Morgan. If you want to meet a senior banker, get an invite to an IIF board meeting.
One of the enigmas of the banking crash which puzzled the Bank of England senior economist Andrew Haldane, however, was the fact that in late 2008 the UK financial sector’s contribution to his country’s total output appeared to be *increasing*. As he has said, “At a time when people believed banks were contributing the least to the economy since the 1930s, the national accounts indicated the financial sector was contributing the most since the mid-1980s. How do we begin to square this circle?”

His answer was offered in a November 2011 paper contributed with fellow economist Vasileios Madouros. They began: “The headline national accounts numbers point to a significant contribution of the financial sector to the economy. For the US, the value-added of financial intermediaries was about $1.2 trillion in 2010 – equivalent to 8% of total GDP. In the UK, the value-added of finance was around 10% of GDP in 2009.” But the headline figures were misleading for two reasons, they claimed. Firstly, although risk management should be treated as an economically productive activity, the act of just taking on risk isn’t – and this is what banks had been doing for decades through leveraging their equity capital. “The current framework for measuring the contribution of financial intermediaries captures few of these subtleties. Crucially, it blurs the distinction between risk-bearing and risk management,” they wrote.

Secondly, the hidden public subsidy being offered to banks, particularly those Too Big To Fail banks, was failing to be reflected, with dramatic results. “The implicit support of the taxpayer and society will show up as an explicit profits bonus to the financial system... Government subsidies – whether implicit or explicit – cannot be said to have added to economic well-being in aggregate. At best, they are sectoral re-distribution of resources from the general taxpayer to the banks”.

And the size of those subsidies, when quantified, were extremely significant: “For the largest 25 or so global banks, the average annual subsidy between 2007-2010 was hundreds of billions of dollars; on some estimates it was over $1 trillion. This compares with average annual profitability of the largest global banks of about $170 billion per annum in the five years ahead of the crisis.”

If this argument is accepted, the corollary is that banks are rather a lot less valuable to the economy than many people – especially bankers themselves – like to think.

There are other ways in which bank performance could be monitored. For example, instead of return on equity, banks could focus instead on their return on assets (ROA). ROA records net income as a proportion of total balance sheet assets rather than just in relation to shareholder equity. This means it strips out the performance advantages which are the result simply of increasing leveraging.

The snag (at least from the banks’ perspective) is that ROA could suggest that – far from being the wunderkinder of the corporate world – banking corporations are generally speaking performing in a pretty mediocre way. So maybe those massive bonuses for top staff aren’t so justified after all.
8

The regulators get busy

Things have of course changed since the events of 2007-8. The regulators, international and national, have got to work. The European Union has accelerated its work to bring about a ‘banking union’ with a new supervisory authority, common rules on depositor protection and restitution. UNI Europa is engaged as a key stakeholder in the process.

Globally, international banking rules are set by the Basel Committee on Banking Supervision. The Basel Committee has developed a proposed new global regulatory standard, known as Basel III. Basel III is still work in progress, but one key principle is that banks are being required to have higher levels of capital immediately available to them in the event of future banking crises. In other words, Basel III is trying to restrict banks’ ability to undertake the extremely high levels of leverage which were the case before 2007-8.

This is undoubtedly a step in the right direction. (Whether it is enough to prevent future re-runs of 2007-8 is a more difficult question to answer. As has been pointed out, the earlier Basel I and Basel II standards were also supposed to achieve this, and clearly failed.) One highly respected economist, Anat Admati, professor of finance and economics at Stanford, is not convinced Basel III does do enough to tackle banks’ reliance on debt. “Basel III equity requirements are the result of a highly political process. They are not based on solid science and are dangerously low,” he has written.

The regulators are in any case influenced by the potential contradiction in tightening capital requirements during a time of recession. If banks have to reduce their total reliance on debt then an easy way for them to do this is to stop lending to customers.

The bankers at the Institute of International Finance have certainly been happy to focus on this issue when lobbying on Basel III. The IIF report mentioned above includes the following: "We believe that further considerable attention should be given to their design. New reforms, which could add to the sizeable burden already in place, need to be carefully thought through… The economic impact of these reforms – in terms of real GDP and employment foregone – will be significant." Elsewhere in the report the IIF claims that US employment will be about 2.9 million lower in 2015 than would otherwise be the case, as a result of the restrictions flowing from financial reforms.

This is pretty transparent special pleading (do banks already really suffer from a ‘sizeable burden’ of regulation?). But there is no doubt that banks are indeed already engaging in deleveraging in anticipation of Basel III, and one easy way they can do this is by turning off the credit taps for their customers. Governments’ pleas to provide capital for businesses have tended to fall on deaf ears. Banks have chosen to cut their lending regardless of the implications this has for the wider economic situation. Small and medium-sized businesses, as well as consumers, tend to be those particularly affected (large companies often can obtain the capital they need from other sources). In other words, the banks having led us into the current economic mess are now by their actions helping to ensure that the economies of many major countries remain depressed.

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The crux of the issue is that banks are trying to anticipate the new regulatory regime without at the same time accepting that their ROEs will need to be lower as a consequence.

9

Watch out for the ‘operational enhancements’

There is another significant way in which banks are trying to maintain their ROE in a tougher regulatory climate – by cutting jobs.

An interesting report from the consultants McKinsey, aimed at a banking audience, discusses ways in which banks can take ‘mitigating action’ to try to protect their ROE from falling too much as a consequence of the need to increase core capital. One such mitigating action is to make ‘operational enhancements’ and the first of these identified by McKinsey is what it calls ‘adjustment’ of front- and back-office head count. Adjustment here is a euphemism for job cuts.

The finance sector has seen a tidal wave of redundancies, particularly in the final six months of 2011 and the early months of 2012. The Eurofound’s European Monitoring Centre on Change reports that over thirty companies in the finance sector have announced job losses of over 1000 positions in the fifteen months from Jan 2011. The complete table is included as an appendix.

These represent in many cases severe cuts in total labour forces, as much as 10% or more from banks such as Bank of America, HSBC and Lloyds. Cuts this deep are being felt particularly by lower-paid bank workers. There is also a gender dimension: analysis of national statistics suggests that women employees have been more affected by job losses in recent years than their male counterparts.

‘Operational enhancements’ of this savage kind are not the only possible stratagem for building up capital levels. Banks, were they to choose to do so, could retain more of their profits in their reserves rather than distributing them out to shareholders as dividends. To quote Professor Anat Admati from Stanford again: “If banks retain their earnings and use them to repay some of their debts or to lend, rather than to pay dividends or buy back shares, equity will build up with little negative impact on the economy and no reduction in lending capacity. Restricting equity payouts until financial institutions are sufficiently well-capitalised is the easiest, least costly way to transition to healthier and safer system.”

Are banks asking their shareholders to share the pain in this way? Well, no. Arguably, the greatest weakness of the post-crisis regulatory reforms is that there has been no obligation imposed on banks in relation to dividend payments and rewards to shareholders. The economist Morris Goldstein has drawn attention to what this means in practice, in an article Stop Coddling Europe's Banks. He writes:

“Any EU bank that was below the capital target should have been directed to stop paying dividends until it reached the new capital target and until it was not in danger of falling back below it over the next year. Clearly some large and under-capitalised EU banks are operating under no such constraints. Banco Santander, for example, is reported to be paying its shareholders at least €2 billion in cash and more in stock in 2011 – at the same
time as regulators estimate that it has a capital hole of at least €15 billion. BBVA, Deutsche Bank and BNP are among others that are expecting to be making significant dividend pay-outs at the same time as they are seeking to raise capital."

10

Tackling the banks’ obsession with profitability

So what? Continuing to criticise the banks can itself invite criticism. Or a big yawn. Shouldn’t we be moving on?

Certainly the banks would like it if we did move on. Bob Diamond, Barclays’ ex-chief executive, said exactly this in 2011 at a hearing at the UK Parliament: “There was a period of remorse and apology; that period needs to be over. We need our banks willing to take risks, to be confident ....” he said. (He has since been obliged to resign, following an interest-rate fixing scandal that has also cost Barclays its Chairman – and a £290 m record fine from the regulators).

Unfortunately, as this report has tried to demonstrate, it is not clear that banks have changed their behaviour in any fundamental fashion. As we saw earlier, the problem before the crash was that whilst bank profits were privatised, the risks were socialised. Effectively this remains the situation today.

Real reform would see moves to socialise the gains as well as the risks of banking.

What might this mean in practice? There are several stratagems which could be adopted, and there is certainly scope for creative thinking around this theme. Changing the ownership structure of banks (for example, by taking them into public ownership) is by no means the only way to socialise gains. The strategic aim, whatever the approach adopted, would be to stress the public good which should come from effective banking. It would emphasis the importance of banks' core role in supporting the development of the real economy, by lubricating the transfer of capital from investors to wealth-creating businesses.

It would acknowledge that banks should be meeting the interests of society as a whole and of all bank stakeholders, not just shareholder investors. In particular, it would acknowledge the key stakeholder role played by banks’ own employees.

As UNI Finance has argued for several years, there needs to be a cultural shift by bank managements. Philip Jennings, UNI General Secretary, has called for an end to what he calls the ‘cesspit culture’ in banking. He has called for bank workers to be represented with seats on the Boards. UNI argues cogently that bank staff's role needs to be seen as delivering high quality levels of service to customers - rather than trying to sell often inappropriate new products.

Socialising the gains which come from banking would not mean disregarding the interests of investors. But it would mean developing a banking sector which was not taking unnecessary risks and not trying to operate to consistently high targets for ROEs.
Meanwhile in the ‘real economy’...

The levels of ROE which banks have been able to enjoy in recent decades, thanks we now know to their leverage and to the tacit guarantee they enjoyed from the public purse, propelled them above the average levels of return which were being obtained in other sectors of the economy. This had a damaging effect in pulling money away from these sectors into the mad money-go-round world of the financial markets – casino capitalism.

It also had the effect, little by little, of pushing up the levels of returns which operated within other sectors. So it is appropriate now to move away from the focus just on banking, and to look at what is happening elsewhere in the economy.

Recent data analysed by Aswath Damodaran, Professor of Finance at the Leonard N Stern School of Business at New York University, demonstrate just how high levels of ROE have been during the current recession. The data for example give average ROEs for the US publishing industry of 23% (24 companies surveyed), of 25% for computer software (184 companies), of 28% for computer hardware and peripherals (87 companies), of 13% for telecom services (74 companies), of 20% for IT services, and 17% for retail stores (37 companies).

ROEs for individual companies can be even higher: IBM obtained 64% ROE in 2010, UPS 43% and Microsoft 40%, for example.

These levels of return reflect a gradual process of ‘inflation’ in the levels of profitability being sought by companies and their boards in recent times. There is a direct inverse relationship with the share of wealth creation which is being given to workers – the labour share or wage share. As The Economist magazine put it recently, “The past four years have been bad for workers and savers but good for the corporate sector. Profit margins in America are higher than at any time in the past 65 years”.

As has been widely noted by a whole series of studies, published by among others the IMF, ILO, OECD and UNDP, the labour share has been declining over the past thirty years. The tables below are taken from an IMF report and show a steady fall both for the aggregated selected advanced economies (Australia, Canada, France, Germany, Japan, the Netherlands, the UK and US) and for the G7 economies.

![Graph showing income share of employees and labor over time](image-url)
Until very recently, this did not generally mean that workers as a whole were worse off, merely that the share of the pie which they got to keep as a reward for their labour was reducing year-on-year. This trend was disguised by the fact that the overall size of the pie was getting bigger.

But the situation is now different: today many workers are most definitely finding themselves worse off in real terms. The graph above, from a recent publication from the Communications Workers of America, shows the situation for US workers.

This makes it even more unforgivable that companies, both in banking and across all sectors, are feeling able to continue to set excessively high targets for their returns to investors.

12
What is happening to company profits?

There must be, though, some benefits from companies being so profitable. Profitable companies help strengthen the economies of the countries they are operating in.

Or should do. One of the problems as companies have globalised is that profits have tended to be repatriated to wherever it is that their investors are located. This flow of money out of domestic economies is often not easy to monitor, but is a particular concern for many developing countries. It has also been picked up recently as an issue in New Zealand, an island economy where four of the major banks are Australian owned. Critics have claimed that these banks took over three billion NZ dollars out of the country in 2011 to pay dividends to their Australian owners.
Nevertheless, you’d think that profitable companies would at least have the capital available for investment in their future development and growth. But here again the reality is different. To quote again from The Economist article mentioned above: “The current high level of profits is not leading to a surge in investment. As a proportion of GDP, American business investment is close to 30-year lows.” In other words, not only are banks withdrawing from investing but companies themselves are failing to use their profits to plan strategically for their futures. It is hard to escape the conclusion that the short-termism behind the scrabble for investor returns remains the completely dominant approach of business.

It is also clear that companies are not paying their fair share of business taxes on the profits they are making. Business tax rates have been falling in recent years in many countries, with some countries prepared to adopt a beggar-my-neighbour approach in an attempt to attract footloose corporations to relocate to them. (The table below, comparing corporate and individual taxes in the US, is again taken from the Communications Workers of America).

![Taxes as Percentage of Federal GDP](http://www.whitehouse.gov/omb/budget/Histcorals)

But even though business tax rates have been falling, this has still not been enough to satisfy business. Global institutions have historically been adept at manipulating their activities so that as large a share of profits as possible can be accounted for in low-tax or no-tax offshore havens. The UK bank Barclays, for example, was recently revealed to have paid only £113m in corporation tax to the UK in 2009, 2.4% of its £4.6bn global annual profit.

13
The executives are licking up the cream

It is time to return to an issue mentioned briefly at the start of this report – the scandal of executive pay.
Despite the dire state of the world’s economy, senior executives have no compunction in paying each other truly astonishing amounts of money.

Rupert Murdoch (News Corporation), for example, received $29.4m in 2011. David Cote (Honeywell) received $35.3m. Martin Winterkorn (Volkswagen) took €17.5m. Bob Diamond (chief executive of Barclays Bank before his forced resignation in July 2012) around £25m. And so the list goes on. The New York Times recently reported that the top 100 CEOs in the US took home between them a total of $2.1 billion, and that the median CEO (the chap half way down the list) received $14,400,000. The average annual American salary is $45,230.

The CWA has focused not just on the pay gap, but on the rapid way that this gap has grown in recent decades. The cartoon below (from their publication Building a Movement for Economic Justice and Democracy) compares the situation in the US in 1980 and in 2010. The change is truly astonishing.

“Outrageous CEO salaries” (that phrase comes from a June 2012 headline in, of all newspapers, the Financial Times) are not just a feature of the US. In the UK, for example, the FT reported that the median total remuneration of bosses of the top 100 quoted companies on the London stock exchange increased by 10% in 2011 (up to £3.7m).
Even though the shareholders of a small number of companies have begun to reject the most excessive pay packages, it would be extremely naïve to rely on investors to lead any sort of resistance to the scandal of executive pay. Rather more useful has been the lead offered by the incoming French President François Hollande, who has tapped into popular anger by committing his administration to operate pay differentials of no more than 20:1 in the French public sector. Unfortunately, private sector companies remain at present beyond his reach.

Also welcome has been the proposed EU move to cap bankers’ bonuses. Nevertheless, pay consultants and remuneration experts have already begun to work out ways round this, including boosting executives’ pension entitlements and creating so-called long-term incentive plans.

Nobody, of course, mentions morality. But inflated executive payments of these proportions should be quite indefensible under any human system of morality. The word to use about executive pay is, quite correctly, ‘obscene’.

14
Socialising the gains, not just the risks

We argued earlier that the banking sector urgently needed to be fundamentally reformed, to focus on the social gains it could achieve rather than simply the private gains for investors. But this message is not one limited to the banking sector.

Other companies in other industries also operate by externalising the costs and risks of their operations, whilst keeping the rewards private. It has long been the case that the state has been expected to pay, for example, the bulk of the social costs which come from large-scale redundancies when a company chooses to restructure. It is the state which provides necessary public infrastructure for companies to utilise, and the state which normally is left to cope with environmental damage created by business operations.

It is a feature too of the privatisation of public services: generally speaking it is the state which remains obliged to provide a safety net to maintain essential services if a private company goes under or decides to exit from the market. (To give a single example: after the post was privatised in Sweden, a number of firms went out of business: one operator failed to take down its letterboxes, whilst at least one other company was unable to buy back stamps it had sold to customers.)

Externalising costs and risks on to society as a whole, whilst keeping the rewards of business private, can be readily perceived to be manifestly unfair. This is a message which can get through. It can also be a response to the ideological attack which has been launched recently on public expenditure.

It is time, in other words, to argue that benefits which come from business should be shared more broadly, and to discuss in detail how we can find twenty-first century ways of successfully socialising the wealth created.
At core, it comes down to asking the question of what is the ultimate objective of business activity. Is it just to maximise ROE and distributed profits? Or should there be something more than this? Should rather the question being asked be: what can business do, not just for itself, but for all?
Finance Watch
Basel 3: return of the Regulator

At the head office of bank One-Stop-Shop

You read the news about the new Basel 3 regulation? The regulator wants to increase bank capital from 8% to 10.5%! These guys are nuts!

Hey wasup, why the gloomy face?

Yeah, I heard of it, why is it a bad thing? Won’t it make banks more resilient?

Course it will but that’s not the point, it means that banks will have to raise new capital, and profits will be divided into a greater number of shares, hence a smaller return on shares, hence a smaller bonus.

Besides who needs to be more resilient when you have the government and taxpayer money backing you in case of trouble?
Right, that sucks, but at least our job is safe, as banks are less likely to crash.

Not even! Even with the new capital rules, if banks’ investments decline by only 5%, they go bust!!

Right, so the new capital requirements are not high enough to make banks really safe. We will get lower bonuses, and my wife wants a new car. Any more good news?

Oh yeah, here is another one: the regulator wants banks to disclose publicly their leverage, which is the ratio of total assets divided by capital, and put a cap on it!
Coining it in: How companies are hoping that it's business as usual

We can no longer borrow all we want and invest like there's no tomorrow. Before, some banks with only 2 euros of capital could borrow 98 euros and invest 100 euros, pocket the margin and both your uncle...

And that is bad because...

It'll put a limit on our investments relative to our capital.

Hold on, 2 euros of capital and an investment of 100? That's a leverage of 50 times! If you lose only 2% on your investment you go bankrupt, that's insane!

Now you sound like a regulator. Remember we cannot go bankrupt, if we're in trouble we just tell governments that if they don't bail us out, depositors will lose their savings, corporates won't get loans etc... Works like a charm every time!

...but with this leverage cap, we will now need to have at least 3 euros to lend 100. What a bummer! Another dent in my condo down payment.
At bank One-Stop-Shop’s local branch
The regulator wants to force us to have more capital and limit our loans and investments, and we are not happy, so we won't lend.

What do you mean on strike??

No, loans are no more than 50% of our investments. Because we want to show him we're unhappy and because we prefer to keep the money to speculate on the markets.

Because you have to limit your lending until you have more capital?

More profit to be made there dude, sorry.
But isn't your job to lend money to corporations and individuals?

Well that's boring banking, much more fun to play on the stock market, and repackage stuff to sell it to dummy investors.

And how do you think I paid for my middle class sports car and the kids' holidays in Barbados?

So what do I do?

You tell your wife it's the economy.
More protests against banks, what do they want? “Stop moral hazard”, what is that again?

It's when banks should go bankrupt but the government saves them with taxpayer money.

Well yeah, but the new rules just make individual banks stronger by requiring them to have more capital. They don’t address systemic risk and moral hazard. If a bank fails today, I bet you the government will still jump in to protect depositors’ money and loans.

Is it still the case? I thought they had these new Basel 3 rules to make the financial system safer.

At the local pub..
That doesn't sound right, so the government lent billions to banks, now banks make money again and governments are super indebted and all...

And you're saying that nothing has been done to prevent that from happening again??

Well it's been hard work to prevent that, am telling you. We weren't gonna let our sweet government insurance go away

But that's rubbish, any other business does not have that kind of insurance

Didn't you listen to the news? We're special!!
Coining it in: How companies are hoping that it's business as usual

Special my foot, why should I pay with my taxes for your mess?

We just need to tell the governments that if they don't help us, it will affect the economy, they will lose millions of jobs, blablabla.

Oh, they probably would have to separate retail banks from investment banks, but forget this idea. Ain't gonna happen.

Any idea how much we spend on lobbying?
Well if enough people tell their elected officials that they are sick of it, things might change!

I'd rather my taxes be used for my kids' education than for your new beach house. Sorry.

People have no sense of humour.
THE END

This is a light-hearted attempt to explain certain issues with Basel III, the text is purely illustrative. For a fuller analysis, see Finance Watch’s February 2012 position paper on CRD IV, “To end all crises?” www.finance-watch.org
Notes

Report prepared by Andrew Bibby
July 2012

Notes on sources used in this report:


Page 4: chart is from European Central Bank (2010), Beyond RoE – How to measure bank performance


Page 5: chart is from European Central Bank (2010), Beyond RoE – How to measure bank performance


Page 8: Americans for Financial Reform, open letter to Secretariat of the Basel Committee on Banking Supervision, Aug 26 2011

Page 8: Andrew Haldane (2010), The Contribution of the Financial Sector, Miracle or Mirage?


Page 10: McKinsey (Sep 2011), Day of Reckoning?


Coining it in: How companies are hoping that it's business as usual
www.economist.com/node/21551485


Page 12: IMF, How has the Globalization of Labor affected Workers in Advanced Economies ? 2005

Page 15: John Gapper, Outrageous CEO salaries rarely reward shareholders, Financial Times, 16 June 2012

Page 18: Finance Watch. Basle 3: Return of the regulator. A light-hearted attempt to explain certain issues with Basel III, the text is purely illustrative. For a fuller analysis, see Finance Watch’s February 2012 position paper on CRD IV, “To end all crises?”. www.finance-watch.org
Appendix – job losses in the finance sector

The table below is taken from data from Eurofound’s European Monitoring Centre on Change, and covers the period Jan 2010-March 2012. Only those job losses where potentially over 1000 post were threatened are shown.

<table>
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<th>Announcement date</th>
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