Institute
and Faculty
of Actuaries

What would be a sustainable economic and finance system for the public interest?

The Frank Redington Prize

by Martin White

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A world of information asymmetry: knowledge is power, and lack of knowledge may mean impotence without access to deservedly trusted voices

I start this paper by setting out the various dimensions of the public interest under which I will be discussing the impact of the financial sector. Then in Section 2, I discuss some of the areas where I believe change would be very much in the public interest, together with some of the circumstances and forces, including misleading messages and the power of corporate lobbying, that have not only led us to where we are today but which range against any processes of thoughtful reform. I consider not only the financial sector and its impact on everyone's financial lives, but also its influence and impact on the behaviours and attitudes of the corporate world, which impacts the working lives of most of the population – something that I see discussed only rarely.

In Section 3, I set out a brief picture of how I would like the financial and corporate world to work - if I could simply wave a wand and the new world just appeared. It helps to have a vision of what "good" might look like.

Back to reality in Section 4, I discuss the challenges involved in achieving change within our democratic processes. Democracy is too precious to lose, but ways need to be found to counter the power of corporate lobbying. In Section 5, I set out a series of suggestions which I hope would have a chance of being taken up with or without cross-party support, without being blocked by the corporate establishment. Implementing these suggestions would, I hope, ultimately lead to material changes addressing the problems set out in Section 2. The power of ideas is great, but worthwhile reform takes time and needs an informed consensus. In section 6, I discuss the problems of winners and losers and in particular the problem that losers would tend to feel the worsening in their situations before the winners really notice the improvements in theirs. This is demanding for political leadership and communications.

It is worth emphasising at the outset that I have not discussed in this paper the problems facing mankind in terms of limits to growth, ecological sustainability, climate change – arguably the biggest issues facing us all. I have concentrated on the way the corporate and financial worlds operate. But in a world where we can no longer expect growth to get us out of financial trouble, the need for the changes I discuss in this paper is even greater.

This paper is the sole responsibility of the author and does not purport to represent the views of any other party.

1 The public interest

This section is where I set out the various aspects of the public interest which I will develop in this paper.

1.1 Introduction – the special nature of the Redington Challenge

I will start by acknowledging the special nature of the “Redington Challenge”, which is how I will refer to the competition to which this paper is a response. Many employers of members of the actuarial profession, and thus arguably many members of the actuarial profession, profit materially from the “information asymmetry” which exists between the financial sector and the public at large, and which makes many parts of the financial sector profitable and well paid, but which results in far from optimal consequences for the personal finances of the bulk of the population.

So for the Institute and Faculty of Actuaries to commission essays that centre on the public interest and the financial sector is a strong demonstration of the profession’s determination to act collectively in the public interest, without interfering in individual members’ duties to their employers and their clients.

As a profession, we have potentially so much to contribute to the public interest, especially helping people to minimise the amount which is extracted from their lifetime wealth by the financial sector, and also to understand the unavoidable nature of the uncertainties involved. We are relatively unique in possessing a deep understanding of the principles of compound interest, which gives us the keys to the kingdom of long term finances. The question is how we can share our knowledge in a way that makes a difference, and this is one of the themes of this paper.

But we should also recognise that we should continually seek to better understand how the world works, and should continually encourage the challenging of accepted wisdom, especially in relation to economic theory. Economic theory tends to be an important driver of decisions by political leaders, and we should speak up when we feel we can usefully contribute.

This paper focuses on the UK situation, but I believe that the broad principles discussed are applicable much more widely.

1.2 The multiple stewardship roles of the financial sector, and the ‘ownerless corporation’; impact on society of corporate cultures

When we talk about the public interest and the financial sector, we tend to focus on consumer/saver outcomes, but also the problems of the bonus culture. It is still well-remembered that in the crisis of 2007-8, the high paid bankers seemed to do better than either taxpayers or shareholders.

However, as well as the stewardship role in relation to customers’ money and the stewardship role in relation to shareholders’ money, the financial sector also effectively controls the majority of quoted businesses. But the financial service business model as currently operated does not lend itself well to engagement as long term responsible owner of the entire quoted sector. Paul Myners coined the term “ownerless corporation” to describe this problem[1].

Just what long term responsible owners[2] should be asking of the companies in which they own shares is something that needs work. The ultimate underlying owners, typically people with interests through pension funds or other managed vehicles, as opposed to people who consciously select individual shares, are generally unaware that they are owners of companies as well as customers and

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[1] Paul Myners gave a wide ranging talk to the IFoA covering this and much else besides in 2018 https://www.youtube.com/watch?v=9nYJExU9Tn4

[2] I knowingly use the term “owner” as shorthand for the underlying shareholders

employees, and a national discussion about how we would want companies to behave might be easier if people felt more aware of this.

But the reality today is that people are in no position to engage, and at the root of this we have information asymmetry and limited financial capability. This brings us to the extreme weakness of most individuals in relation to personal finances, especially long term personal finances.

1.3 The needs of individuals to manage their finances, including saving for the long term

This needs little explanation at this point. I will discuss how serious and difficult are the problems faced by individuals today in the next section.

1.4 Financial stability

We know that major financial crises are very damaging. But the perceived self-interests of the "insiders" in financial institutions and wish of politicians to be seen as the bearers of good news lead us in dangerous directions. I will draw attention to some commentary that I believe to be especially useful to inform policymakers, and will also make some technical suggestions in relation to a collective self-delusion mechanism known as "the bezzle[3]".

1.5 Knowledge – and proper understanding – is power for individuals, and supports wiser decisions by policymakers too

Some individuals will put a conscious effort into finding out what they need to know in relation to, for example, long term savings. They will know that the financial sector is not the place to go to find out how to be an intelligent customer of the financial sector. But most people, with reason, don't know who they can trust to help. This situation needs a total transformation.

There is also a problem for policymakers in finding "experts" who are both knowledgeable and will speak purely in the public interest, and consequently in practice policy is heavily influenced by lobbying. The term "regulatory capture" is commonly used. How should well-meaning policymakers tackle this? Is it too daunting a challenge even to think about?

2 Scope and scale of the problems

The Redington Challenge asked, among other things, for a "wide-ranging paper on what has gone wrong in the last 30 years in the context of the British and Anglo-Saxon financial services industries". Rather than writing a substantial book, space limitations dictate that I cover the topic at a fairly high level. Many of the things I have to say will be controversial to some, who would much rather that the messages be suppressed. However, they are based not just on many years of my own thinking and observation but also on an extensive literature of books, papers, talks and even "official" publications by or for arms of Government.

Whilst the ideas I shall be putting forward later for changes are not consciously copied from anyone else, I believe that my analysis of the situation today is well supported by multiple sources, and at the end of this paper I shall list many of these as suggested further reading. In spite of the fact that for the nation as a whole, limited financial capability combines with misleading marketing messages, there are many well-informed and thoughtful pieces out there, providing you put in the effort to seek them. Indeed, my impression is that for most of these writers they are motivated much more by the opportunity to contribute in the public interest than to make money out of selling books.

[3] I discuss the "bezzle" towards the end of this paper.

In some senses the answer to "what has gone wrong" is that a bad situation, clearly against the public interest, has been allowed to persist rather than actually get worse, and I shall illustrate this with a number of examples.[4] This is certainly the case in respect of individuals and long-term savings, especially if you use conventional financial advisers. Admittedly, good value and simple options do exist if you know what you are doing, but you are unlikely to be put into them by conventional financial advisers. The Financial Conduct Authority has permitted, I believe quite consciously permitted, the industry to continue to operate with minimal effective price transparency.

In relation to corporate behaviour generally, I see no obvious changes to the bonus culture, and no move away from rewards based on share prices or earnings per share, often judged over short periods. This is in spite of good evidence presented to Parliament arguing for change. Clearly the financial sector is complicit in this, and the most extreme bonus culture may exist within the financial sector itself.

The other "public interest" angle I mentioned in Section 1 was financial stability. It would appear that policymakers never learn. Following a financial crisis, there is much talk of reform, but the financial industry insiders always argue for relaxations that permit them to gamble even more extremely with other people's money, and ultimately they seem to be given what they want. As a consequence, the financial system becomes more risky again. This is far from being a UK problem only; it is a problem internationally. There is a deep reluctance to face up to and admit problems, especially if doing so will lead to pricking asset price bubbles. Politicians sometimes respond to crises in ways in which may lead us into the likelihood of even worse crises in future. An authoritative and highly respected commentator on this problem, which is international and related to the unsustainability of debt, is William R White. He is a retired Canadian central banker and economist and until April 2018 he was the chairman of the Economic and Development Review Committee at the OECD in Paris. Very accessible writings and talks can be found at www.williamwhite.ca.

2.1 Information asymmetry, and the problem of who to trust: decades of regulatory reluctance

What do people need to know and understand to make decisions in different contexts? When, and to what extent should they be expected to rely on others? And what duties should sit with those providing advice? Here I will consider individuals making financial decisions for themselves or their families, the outcomes of which may not be apparent for many years. I will then consider the situation of policymakers – including those charged with making the law of the land.

For individuals making financial decisions, given that relatively few people are both able *and* minded to research thoroughly for themselves, what they need is completely trustworthy sources of information and, where necessary, advice. But they also need to be able to trust all the intermediaries in the investment chain to act in the client's best interest. The need for stewardship, the lack of a fiduciary duty, a bias to action in the case of fee-based advisers – all these were thoroughly discussed in the Kay Review (2012)[5] and a number of recommendations made, including that a fiduciary duty be imposed in law on all the participants in the investment chain. The fiduciary duty requirement was one of the most important recommendations of the Kay review. Yet it did not happen and has not happened. Parliament listened to lobbying by the financial sector and the consumer interest has lost out.

Some 10 years before the Kay review, the Sandler review into retail savings was published. The ultimate consequence of this was that commissions to advisers by product providers were banned.

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[4] The refusal by Government to require a fiduciary duty throughout the ownership chain is one strong example.

[5] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf. Some 10 years prior to the Kay review, Ron Sandler was commissioned to conduct a study into retail savings: https://webarchive.nationalarchives.gov.uk/ukgwa/20100401165710/http://www.hm-treasury.gov.uk/medium_and_long_term_retail_savings_in_uk.htm.

This changed the landscape for the good, but other recommendations for charge-capped products were less successful. One of the recommendations that did not get taken up was in para 143 of the Summary report, that intermediaries should not describe themselves as “advisers” unless they met an independence condition. We can see a pattern here – Parliament and the regulatory arm of government find it incredibly hard to make changes that increase the power of the consumer relative to the financial sector. For a colourful picture of the sales culture that exists within the financial sector, try googling “St James Place sales culture”.

Another powerful illustration - Not long after the Kay Review reported, Daniel Godfrey, the Chief Executive of the Investment Association, resigned in 2015. His mistake – developing a 10-point statement of principles to which a number of fund managers signed up. These were as follows:

1. Always put their clients' interests first and ahead of their own
2. Take care of clients' money as diligently as they would their own
3. Only develop, offer and maintain funds and services designed to add value for clients and help them achieve their financial goals
4. Maintain and apply the investment and operational expertise needed to meet the objectives agreed with clients
5. Make all costs and charges transparent and understandable
6. Disclose to investors the source and value of any other material benefit they receive as a consequence of their role as investment manager
7. Ensure regular, timely and clear lines of communication with clients
8. Set out clearly their approach to the stewardship of client assets and interests
9. Maintain a corporate culture that sustains these principles
10. Work with industry colleagues and stakeholders to develop and maintain guidance on industry best practice

It is hard to see any of these as an unreasonable imposition on the investment managers. And as an attempt to ensure that they could actually deserve the trust of the clients, it was clearly attractive to the 25 fund management groups that formally indicated their support for the principles.

However, a number of fund management groups threatened to resign from the Investment Association unless the principles were ditched, and in October 2015 Daniel Godfrey was forced to resign.

It would be hard to find a more revealing story than this. But it is far from the only story about a reluctance to rock the non-transparency boat. I believe an interesting picture emerges when we consider the activities and pronouncements of the Financial Conduct Authority (FCA). The public would be forgiven for thinking that the purpose of the FCA is to protect and advance the interests of consumers. But if you look at the legislation setting up the FCA, it is not as simple as that. A cynic would say that the real intention is to promote the profitability and reputation of the financial sector as a very large contributor to the UK Exchequer. That it is a large contributor, especially though the taxes on the salaries of the sector, is not in doubt. But what is really going on is that wealth is being extracted from largely unaware consumers, with the consequence that those consumers will be materially poorer in retirement than they need be. That extraction process is often subtle and very non-transparent, especially for retail consumers that are put into active funds by their advisers instead of the cheapest possible passive routes.

We could consider this process a form of voluntary taxation – if you know how, it is quite possible to organise your long-term savings in ways that involve extremely low expenses. On the other hand, most people will not know how, and will not know who to ask to be told the truth, so we could consider it a form of involuntary taxation of savers.

Having set the scene a bit, back to the FCA. I believe that the FCA contains many people who care about the lot of the consumer and are completely aware how serious is the level of ultimate detriment to their financial outcomes that people can suffer from expenses. However, I do not believe that they are permitted to put this concern into practice. They are under huge pressure from the financial sector not to do this, and I believe that the Treasury, the ultimate masters of the FCA, side with the financial sector.

In 2015, the FCA started work on its "asset management market study". This was an excellent piece of work. Here is paragraph 1.5 from the Executive Summary to the study's interim report, published in 2016.

> "1.5 Figure 1.2 compares the net return on a £20,000 investment over 20 years to show the impact of charges. Assuming, for illustrative purposes, that both funds earn the same return before charges (the average FTSE all share growth), an investor in a typical low-cost passive fund would earn £9,455 (24.8%) more on a £20,000 investment than an investor in a typical active fund, and this number could rise to £14,439 (44.4%) once transaction costs have been taken into account. We recognise that some investors in actively managed funds are likely to expect higher returns in exchange for the greater risk they are taking on"

Clearly we have to take into account transaction costs: the illustration suggests passive is 44.4% better over 20 years. However, that percentage is not determined purely by the differential in costs; it is also a function of the market return assumed before costs and therefore easy to misinterpret. Pulling out the cost differential, the overall fund (as opposed to the gain) after 20 years is just over 27.3% higher for the passive compared to the active route. Extending this to 40 years we would have 1.273*1.273 = 1.621, so after 40 years the passive investor would be 62% better off than the active.

And there is another angle to add to this. If you were put into the active fund by a financial advisor who charges you say 0.5% of your assets each year as a fee, after 20 years this would reduce your fund to 90.46% of what it would have been, i.e. by approximately 9.5%. So comparing a passive fund without the financial adviser with an active fund with an adviser charging 0.5% (and we must remember that the financial adviser fees are charged on capital and do not reduce any taxes due on investment returns), instead of the 27.3% difference we get 40.7%. This is calculated as 1.273/0.9046 = 1.407. Extending this over a 40 year period, we get 1.407*1.407=1.980. The passive investor avoiding adviser fees of 0.5% achieves, over a 40 year period, around double the ultimate fund of the active investor suffering those fees as well as the higher active expenses. This illustrates the importance of expenses over long periods. For pension saving, you save over your working lifetime, so each bit of saving has a different length of time to accrue, but there is also the time in retirement to consider. A young person today might in practice retire at age 70 and live for a further 25 years after that. Expenses during retirement matter too.

Moving to the final Asset Management Market Study report published in 2017, I have reproduced below in italics the final findings on price competition and the first three paragraphs on performance:

Price competition

1.9 We find weak price competition in a number of areas of the asset management industry. Firms do not typically compete on price, particularly for retail active asset management services. We carried out additional work on the pricing of segregated mandates which are typically sold to larger institutional investors. This showed that prices tend to fall as the size of the mandate increases. These lower prices do not seem to be available for equivalently sized retail funds.

1.10 We confirm our interim finding that there is considerable price clustering on the asset management charge for retail funds, and active charges have remained broadly stable over the last 10 years. We agree with respondents who said that, in and of themselves, price clustering and broadly stable prices do not necessarily mean that prices are above their competitive level. However, we also found high levels of profitability, with average profit margins of 36% for the firms we sampled. Firms' own evidence to us also suggested they do not typically lower prices to win new business. These factors combined indicate that price competition is not working as effectively as it could be.

Performance

1.11 We looked at fund performance, and the relationship between price and performance. In our additional analysis, we found substantial variation in performance, both across asset classes and within them. However, our evidence suggests that, on average, both actively managed and passively managed funds did not outperform their own benchmarks after fees. This finding applies for both retail and institutional investors.

1.12 We looked at whether some investors, when choosing between active funds, may choose to invest in funds with higher charges in the expectation of achieving higher future returns. However, our additional analysis suggests that there is no clear relationship between charges and the gross performance of retail active funds in the UK. There is some evidence of a negative relationship between net returns and charges. This suggests that when choosing between active funds investors paying higher prices for funds, on average, achieve worse performance. Similar academic studies of the US mutual fund industry have typically found a negative relationship between fund charges and fund performance.

1.13 It is widely accepted that past performance is not a good guide to future performance. We find that it is difficult for investors to identify outperforming funds. This is in part because it is often difficult for investors to interpret and compare past performance information. Even if investors are able to identify funds that have performed well in the past, this past performance is not likely to be a good indicator of future performance. There is little evidence of persistence in outperformance in academic literature, and where performance persistence has been identified, it is persistently poor performance.

This was really good and balanced work. The problem is follow-through.

The next story related to the FCA is their 2020 "Call for input" into Consumer Investments.[6]

This is what we read at the top of the relevant web page: "Reducing harm in the Consumer Investment market was identified as a business priority in the FCA's 2020/21 Business Plan. Some areas of the market aren't working well enough for consumers. This call for input looks across the whole market and considers whether there are systemic issues that need to be fixed."

Isn't there a pattern here? Might the situation not be different if the recommendations of previous reviews had been implemented properly?

The "Call for Input" document itself is extremely revealing. The Foreword is frank about the problems:

- "The consumer investment market is not working as well as it should. Too often consumers receive lower returns than they should because of unsuitable products with high fees."
- "The overwhelming majority of retail investors are best served by *readily understood, well-diversified and low-cost investments which are already available from a range of providers* [my emphasis], but many retail investors don't choose these."

[6] https://www.fca.org.uk/publications/calls-input/consumer-investments

- “We need the system as a whole, including regulation, to work better for consumers.”

However, none of the specific questions in the Call for Input would lead to policy changes that really tackle the problem. What people need is to be pointed to the *readily understood, well-diversified and low-cost investments which are already available from a range of providers*. But it’s not in the interests of financial services providers for this to happen.

In the FCA’s current strategy document[7] the word fees appears once and the word expenses not at all. They are doing nothing to encourage price competition or to empower consumers in relation to price. Clearly the current regulatory arrangements are never, ever, going to put the needs and interests of ordinary people first.

This poses the question; how can consumers ever hope to find what they need to know? What can be done about it?

From the FCA’s Foreword, it is clear they know which are the readily understood, well-diversified and low-cost investments which are already available from a range of providers. Despite that, because they feel unable to suggest a solution whereby this information becomes freely available public knowledge, they permit consumers to continue getting a raw deal.

Since the regulatory regime is currently not grasping this problem, and financial services providers have no economic incentive to do so, there is a huge gap where a respected truth-telling body needs to get involved.

Competition will not stand a chance of working unless consumers have ready access to the fundamental truths about investment, freely shared without the financial sector’s spin.

However, I believe that the actuarial profession may just be able to help here, in a way that some will find unexpected, and I discuss this in Section 5.

2.2 Information asymmetry as it affects policymakers and policymaking

There is an interesting article by John Kay from 2011, originally published in the Financial Times: Don’t listen to lobbyists: they never go away.[8] Quoting from this:

“Public opinion, well briefed and properly marshalled, is a decisive force in public policy. But since there are many issues in public debate, attention to any one is necessarily transient. The attention of vested interests to their own concerns, however, is permanent.”

The primary context of the article was banking. But it is for Parliament as a whole to grasp this nettle. Institutional arrangements and practices need to be brought in that recognise the problem and that ensure that the public interest is properly represented and that “experts” are found that can be relied on to give fully balanced advice.

This issue is a controlling one in relation to every topic discussed in this paper. Unless solutions are found to mitigate the problems, the damaging impacts on society of an exploitative financial sector and a corporate sector that does not behave as ordinary people would wish it to will continue unchecked.

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[7] https://www.fca.org.uk/publication/corporate/our-strategy-2022-25.pdf

[8] https://www.johnkay.com/2011/09/21/dont-listen-to-the-lobbyists-they-never-go-away/

2.3 The behaviour and cultures of companies, including non-financial companies, and the many impacts on society

The problems of short-termism, management greed, the malign impact of remuneration consultants; all these are well known. The idea that managers should be rewarded for creating "shareholder value", assessed as the impact of dividends plus changes in share prices over short periods, is at the root of the problem. Tackling this needs a deep and thoughtful dialogue. Sadly, one of the wisest contributors on this subject, Peter Montagnon, died recently. His suggestion was that executive pay should not involve dilution of shareholders, should simply be in cash, and that executives should be encouraged to use their own money to buy shares in the market and hold them for long periods.

It is my contention that there is not enough thinking about how circumstances drive behaviour. Trying to tackle behaviour through regulatory rules does not work if the true incentives are to get around the rules. Incentives tend to lead to unintended consequences, and a better outcome may be achieved by simply paying well in cash and trusting people to do the "right thing", unencumbered by specific targets. And the "right thing" needs to include the success of the business as a whole, having regard to the wider considerations that already exist in the UK Companies Act.

But achieving changes along these lines is hampered by the matters discussed above – information asymmetry as it impacts policymakers and policymaking. And moving to a pay regime that supported the kinds of corporate cultures we would want to see would involve a massive reduction in executive pay.

2.4 Financial stability – huge conflicts with the interests of managers of financial companies

This is really an extreme example of the more general problems of corporate behaviour and culture mentioned above. But financial companies can do massive damage to the economy when they put financial stability at risk. The problem of which experts to trust, when considering policy decisions is as strong as ever. In addition to the powerful self-interests of the managers in many financial businesses, especially in the banking sector, the problems are unfortunately exacerbated by financial theories that are too simplistic and do not fit the facts, and policies are being adopted internationally that risk serious debt crises. There are many authoritative voices on this, but William R White[9] and Steve Keen are worth a look / listen.

One of the terms used to describe the use of more and more debt is "financialisation". A powerful description of how it permits managers of many financial institutions to grow wealthy against the interests of not only the general public but also sometimes their shareholders can be found in a paper "Financialisation: What it is and Why it matters" by Thomas I. Palley.[10]

2.5 Financial knowledge of legislators

There is no reason why career politicians should possess a deep knowledge of finance. My suspicion is that an education that includes a heavy dose of neoclassical economics is not going to help. Having a wide range of experiences and education will clearly help. But if we could tackle the "who to trust" and "don't listen to lobbyists" problems, it is possible that access to a more holistic and detached view of the operation of the financial world could be achieved. Paul Myners liked to illustrate the problem with a question he would ask senior politicians: If interest rates fall, do bond prices go up or down? And how sure are you of your answer?

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[9] www.williamwhite.ca Steve Keen's books "Debunking Economics" and "The new economics – a manifesto" are worth a look, and a presentation https://www.youtube.com/watch?v=iRpoVDAWovE at includes a demonstration of a model that explicitly incorporates the impact of debt on the behaviour of the world economy. The title of the presentation is "System dynamics must supplant equilibrium modelling in economics"

[10] https://www.levyinstitute.org/pubs/wp_525.pdf

3 If I could wave a wand, "good" might look like this

- A "who to trust" body, completely independent of the financial sector, exists to promulgate the truths about finance, and to highlight the best value solutions.[11]
- As well as its own material, the "who to trust body" points people to good sources of education and knowledge.[12]
- In consequence, a much better financially empowered society.
- Vast amounts of cost are removed from the ownership chain, as a consequence of better financially empowered consumers.
- Financial coaching is the norm, rather than financial advice. Coaches charge for time spent only.
- Financial coaches are permitted to point towards the best value solutions without needing to be regulated financial advisers
- The sufferers of life-changing motor accidents that need care for the rest of their lives and are entitled to insist on a periodic payment order are encouraged to do so and are required to be provided with independent actuarial advice, paid for by the liable insurer, rather than necessarily accepting a lump sum.
- The "who to trust body" publishes and develops teaching materials that are available in schools but are also used in adult education.
- Through greater public understanding of finance and the economy, and the awareness that we are all, to some degree, "owners" of business as well as workers in business, there is a continuing and well-informed debate on what corporate cultures should feel like for employees, leading to simpler and lower executive pay.
- The financial sector is much smaller, the savings outcomes for individuals are much better than they would be without this change, and lots of very able people now work in other parts of the economy. Inequality is reduced as a result of smaller top pay packets on the one hand, and much less financial sector wealth extraction across society on the other.
- Parliament has a better grip on the dynamics of the financial system, and policies prevent booms and financial excess from being as extreme as they have been in the past.

4 Prospects for change: back to reality

4.1 Democracy – good! – but too captured by lobbying and vested interests

From the discussion in Section 2, it will come as no surprise that I despair of the political system, with Parliament's current institutions, tackling the problems in any systematic way.

What is more likely to happen is that we will have yet more crises, and ill-thought-out, urgent "solutions" will be imposed that do not work at all.

We live in a complex, continually evolving world and need to adopt strategies that include ideas like resilience, modularity, redundancy. We don't want problems in one area to bring the whole thing tumbling down.

[11] The simple solutions that sophisticated investors use, such as avoiding advisers altogether, SIPPs and ISAs that charge fixed fees rather than percentages, and where the funds can be invested in the cheapest possible passive solutions, are not promoted by the financial media. It's a story you only need to tell once.

[12] Some examples: John Kay: "the long and the short of it" and "other people's money". Warren Buffett – essay on pensions 1975 for Washington Post, published in 2014 in https://www.berkshirehathaway.com/2013ar/2013ar.pdf. This is a powerful treatment of active and passive investment as well as much else, and answers much typical "misinformation" popular in use today by the financial sector.

So we need to work proactively to understand the world, and "we" means all walks of society and all types of expertise and experience.

It is interesting that the Welsh Parliament has established an office to think about the interests of future generations. This sort of initiative is non-party political and may lead to all sorts of good things.

So apart from setting up bodies, parliamentary committees, etc. whose brief is to look at everything from a long-term perspective, through the generations, I am not going to presume that a political decision, for example, to reconstitute the FCA to have a sole brief of consumers' interests, has any chance of happening in the foreseeable future.

4.2 A reminder of the power of those lobbies

Even within the Institute and Faculty of Actuaries, raising the question of financial service expenses in public discussions may be viewed by some as "controversial". So can there really be a role for the IFoA here? Well, maybe, as I will explain in the next section.

5 Some tentative steps in the right direction: start with the potential power of knowledgeable volunteers without conflicts, and a few other suggestions

Many of us will have had discussions with retired people from the financial sector along the lines "I'm not very proud now of what we did".

Where will you find people who have a really deep knowledge of finance and investment? Apart from a few self-taught private investors, the answer is going to be within the financial sector.

But where will you find such people who are not prevented from speaking by conflicts which would damage their careers? The answer is the same people, once they are retired.

5.1 The guerrilla option – A body of retired people with a shared passion to broadcast freely the essential truths about finance and investment, independent of all conflicts

There is no need to spell out what this would involve. The body just has to get started, and its existence publicly discussed.

5.2 Actuaries are the natural profession to supply a large proportion of these retired public interest crusaders

Now, is this something that the IFoA would be happy to be directly involved in? In practice the IFoA, and indeed the international actuarial community, operates through volunteering, and it may be sufficient for there just to be some discussion within the profession's discussion forums, the Actuary magazine, etc.

5.3 Retired people and the community

Wanting to feel you are contributing is an important motivation for most of us, and as society ages, this is likely to be an increasing trend, so collaborating in what is close to a form of education for younger generations would be a natural thing for those with the knowledge and capability to do.

5.4 The unpredictability of how this might unfold

"A long journey starts with a single step" is a pretty trite comment but it applies here. Change will take time; how quickly and precisely how it will happen is impossible to predict. But for those involved, that would be part of the fun. A growth in public awareness of how society as a whole works, an improvement in financial capability and empowerment, a financial sector genuinely deserving trust (!), an increase in savings levels, an increase in levels of investment by companies who now have a

longer-term mindset – we can dream about what might happen and when. But any step in the right direction is worth taking.

5.5 The financial, corporate, and other lobbies could not stop it – providing we keep our democracy and free speech

This is probably the most important thing of all. What we have here is the idea of volunteers speaking out freely. And in due course, it would not matter so much if the FCA does not change its priorities – a genuinely trusted volunteer body would be listened to by consumers anyway.

5.5 How "we" would like "our" companies to behave is a discussion that this independent "who to trust" movement could encourage.

Before I finish this section, I will turn to a quite different problem.

5.7 A quite different suggestion regarding financial stability – to tackle an aspect of weapons of mass financial destruction – derivatives.

Some years ago, in the London Insurance Market, there was an oil rig called Piper Alpha, which blew up. This was a large insurance loss; I forget how big. The insurance was largely placed in the London Insurance Market.

However, the insurers that all took shares in the direct loss had no intention to "retain" all of it themselves. So as part of their underwriting programmes, they bought reinsurance on an "excess of loss" basis. However, they frequently also sold reinsurance to other underwriters.

Reinsurance was of essentially two types – reinsurance of direct alone, and reinsurance of the sum of your direct losses and your reinsurance losses.

Stage 1 – the direct loss was paid, and the reinsurers of the direct insurers were presented with the "first round" reinsurance claims triggered by the direct losses.

Stage 2 – the reinsurers then looked at their total Piper Alpha loss so far, and if they had any reinsurance left they paid their reinsurance claim and presented an outwards "retrocession" claim to their own reinsurers.

Stage 3, and 4, and 5 etc. – the losses were passed round and round until the reinsurers ran out of outwards cover.

This had two interesting consequences. First, for those who had given reinsurance that covered their cedants' inwards retrocessions, what determined their ultimate losses was whether they ran out of reinsurance themselves, and therefore could not pass the loss on any further. This was insurance as a process of concentration rather than spreading – far from what was intended.

The second consequence resulted from the process and time involved in advising the losses to reinsurers, reinsurers noting the losses, reinsurers advising the losses to their reinsurers and so on. The market as a whole was having trouble estimating what its net losses would be.

Whilst it was not possible to be confident what your own ultimate losses would be until advices had definitely stopped, it would have been possible for the central market authority to request, as at a specific date, details of how much each participant had been in receipt of advices on the one hand, and details of how much had given in terms of advices on the other, split between advices that would have been early enough for the counterparty to have logged and processed them, and not early enough to have been logged and processed by the counterparty.

The reason I tell this story is that I think there may be parallels in respect of derivatives. Banks and other institutions deal massively in derivatives. However, where they are not marked to market, but

instead to model, there is massive scope (indeed likelihood) for there to be a massive aggregate "bezzle", whereby there is a collective delusion as to the financial state of the system. I can estimate the value of a trade with you, as a win to me of 4, and you can estimate it as a loss to you of 3.8. In aggregate we are deluded that we are worth 0.2 more than we really are. I believe that unless this is tackled, we are at risk of another 2007-8 type crisis, prior to which I think there was an element of collective self-delusion, and where I suspect that some of the profits reported prior to the crisis, on which taxes, bonuses and dividends were paid, were imaginary. And it needs to be tackled internationally by some form of logging, as at a specified date, of the values placed on all trades and also the identity of the counterparty. I believe the possibility of harm may be exacerbated by the introduction of derivatives that gamble on crypto-currencies.

My recommendation is for regulators and stewards of financial stability to give additional attention to derivatives, if they are not already doing so.

5.8 A new office for the future, set up by the UK Parliament, to follow the Welsh

I referred to this idea earlier.

6 Winners and losers: levelling-up and the impact on society as a whole

This topic is demanding for political leadership and communications.

If our society moved towards much greater financial empowerment of individuals, supported by first a legal requirement for the financial sector, including the advice sector, to adopt full fiduciary standards then:

6.1 Reform now, and the pain would be felt more immediately than the gain

This is one strong reason why we have had limited reform in terms of the lot of the consumer of the financial sector.

The extreme current levels of information asymmetry, corporate short-termism and bonus pay culture are such that tackling them would have significant winners and losers. The obvious losers would be the profits of the financial sector, jobs in the financial sector and some of the extremes of high pay seen at the top of corporations.

Less wealth would be extracted from the savings of consumers across society and funnelled to the South-East where the high paid financial sector jobs tend to be. This would lead to considerably better financial outcomes for consumers across society – today pension and other savings outcomes are worse than they need be simply because a large proportion of the return is lost in charges.

But if I save total expenses of say 2% on my pension pot today, and I am aged 40, I will not actually experience the benefit until I retire, which could be 30 years hence.

6.2 But a volunteer-based consumer informing body would have a slower impact

Another reason for thinking that this would be more likely to succeed.

7 Some books and a few other resources

There is a mass of work that can be found that touches on the themes in this paper. In this section, I refer to just a few items that I have found particularly helpful. Omission of a piece of work from this list does not indicate that it is any less valid.

I give a few specific links in footnotes throughout the paper and will generally not repeat them here.

The key theme in the paper is the ability of many actors within the financial sector to extract wealth from its customers, the information asymmetry between sector and customers which permits this, and a radical suggestion to create a voice to counter this asymmetry. Also touched on in the paper are information asymmetry between legislators and the industries subject to legislation and regulation, the conflict between the objective of financial stability and the interests of the managers of financial companies, the need for an informed discussion about what corporate cultures we would wish to see across all businesses, and the need for thinking about how circumstances actually drive behaviour.

Deliberately not covered in the paper was the mass of information and ideas that the radical suggestion put forward would lead to being publicly discussed, understood and acted on. That includes unbiased sources of essential finance and investment knowledge. But some of the items listed here are important sources of such information and ideas.

I have found each of the items listed below to be useful in thinking about one or more than one of the themes mentioned above.

1. Stephen Davis, Jon Lukomnik, David Pitt-Watson *What they do with your money: how the financial system fails us and how to fix it* Yale University Press, 2016
2. Roger Bootle (hon fellow IFoA) *The trouble with markets: saving capitalism from itself* Nicholas Brealey Publilshing, 2011
3. John Kay *The long and the short of it: finance and investment for normally intelligent people who are not in the industry* The Erasmus Press, 2009
4. John Kay *Other people's money: masters of the universe or servants of the people?* Profile Books, 2015
5. Tim Hale *Smarter investing: simpler decisions for better results* FT Prentice Hall, 2009
6. Iona Bain *Own it: how our generation can invest our way to a better future* Harriman House, 2021
7. Glen Arnold *The Financial Times guide to investing: the definitive guide to investment and the financial markets* 4th Edition Pearson, 2014
8. Benjamin Graham, 1973 *The intelligent investor: a book of practical counsel* HarperBusiness Essentials, revised edition Jason Zweig, 2006
9. George Cooper *The origin of financial crises: central banks, credit bubbles and the efficient market fallacy* Harriman House, 2010
10. Andrew Smithers and Stephen Wright *Valuing Wall Street: protecting wealth in turbulent markets* McGraw-Hill
11. Andrew Smithers *The road to recovery: how and why economic policy must change* Wiley, 2013
12. Andrew Smithers *Productivity and the bonus culture* Oxford University Press, 2019
13. Andrew Smithers *The economics of the stock market* Oxford University Press, 2022
14. Steve Keen *Debunking Economics: the naked emperor dethroned?* Zed Books, Revised and Expanded edition, 2011
15. John Plender *Capitalism: money, morals and markets* Biteback Publishing, 2015
16. Colin Mayer *Prosperity: better business makes the greater good* Oxford University Press, 2018
17. High Pay Centre, multiple authors including Peter Montagnon, *Performance pay: new ideas on directors remuneration,* hpc_Essays_FINAL_06_WEB.pdf (highpaycentre.org) or https://highpaycentre.org/wp-content/uploads/2020/09/hpc_Essays_FINAL_06_WEB.pdf November 2014
18. John Kay https://www.johnkay.com/2017/01/16/corporate-governance-beis-select-committee-written-evidence/
19. William White, http://williamwhite.ca/2021/03/28/the-full-case-against-ultra-low-and-negative-interest-rates/ (essay on financial stability)
20. Warren Buffett *Letters to shareholders 1977-2021 Available at www.berkshirehathaway.com*

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Beijing

14F China World Office 1 · 1 Jianwai Avenue · Beijing · China 100004
Tel: +86 (10) 6535 0248

Edinburgh

Level 2 · Exchange Crescent · 7 Conference Square · Edinburgh · EH3 8RA
Tel: +44 (0) 131 240 1300

Hong Kong

1803 Tower One · Lippo Centre · 89 Queensway · Hong Kong
Tel: +852 2147 9418

London (registered office)

7th Floor · Holborn Gate · 326-330 High Holborn · London · WC1V 7PP
Tel: +44 (0) 20 7632 2100

Oxford

1st Floor · Park Central · 40/41 Park End Street · Oxford · OX1 1JD
Tel: +44 (0) 1865 268 200

Singapore

5 Shenton Way · UIC Building · #10-01 · Singapore 068808
Tel: +65 8778 1784

www.actuaries.org.uk

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