



Does Finance Benefit Society?

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April 2019

£119 billion

Value of UK financial services sector in 2017

3x as large as in France or Germany

IB salaries: £72k (entry-level), £329k (10 years)

UK economy lost out on £4.5 trillion because of 'too much finance', study finds

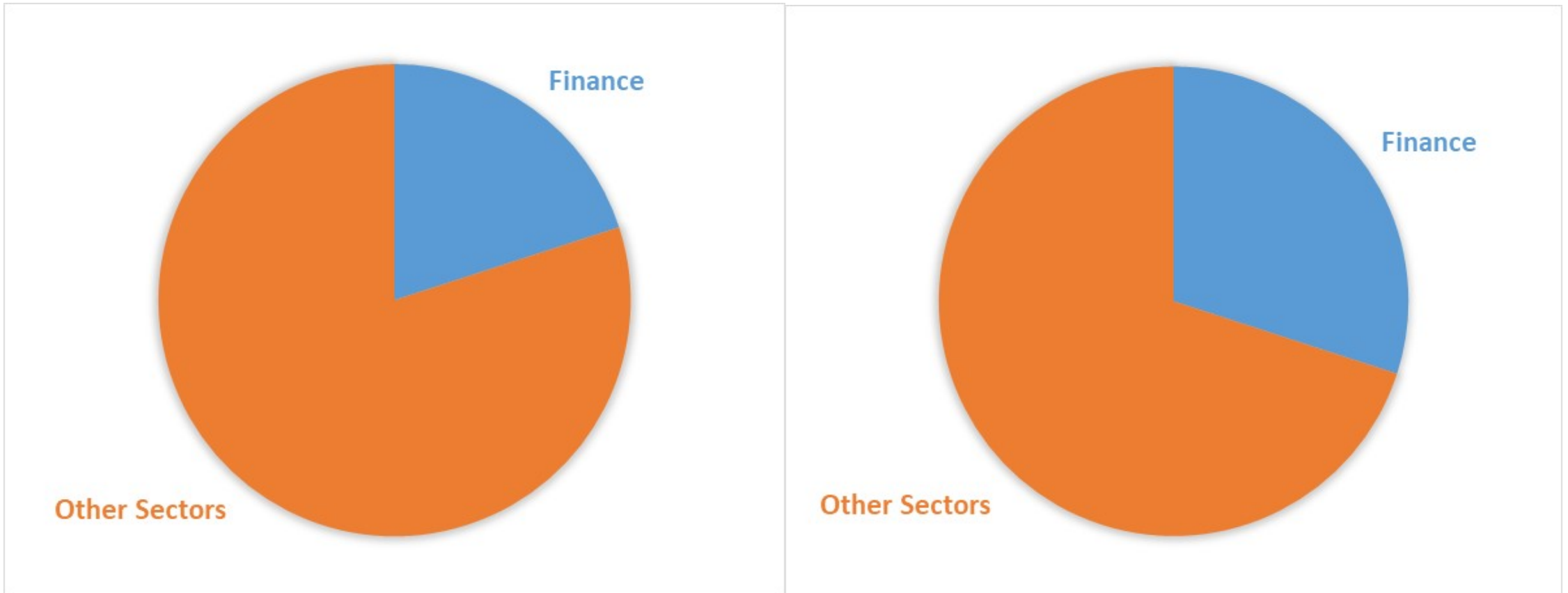
'Finance curse' sucks talent and investment from other industries, costing £67,500 per person over the course of two decades, say researchers

C is the ratio of private credit to GDP and thus stands for the size of the financial sector.

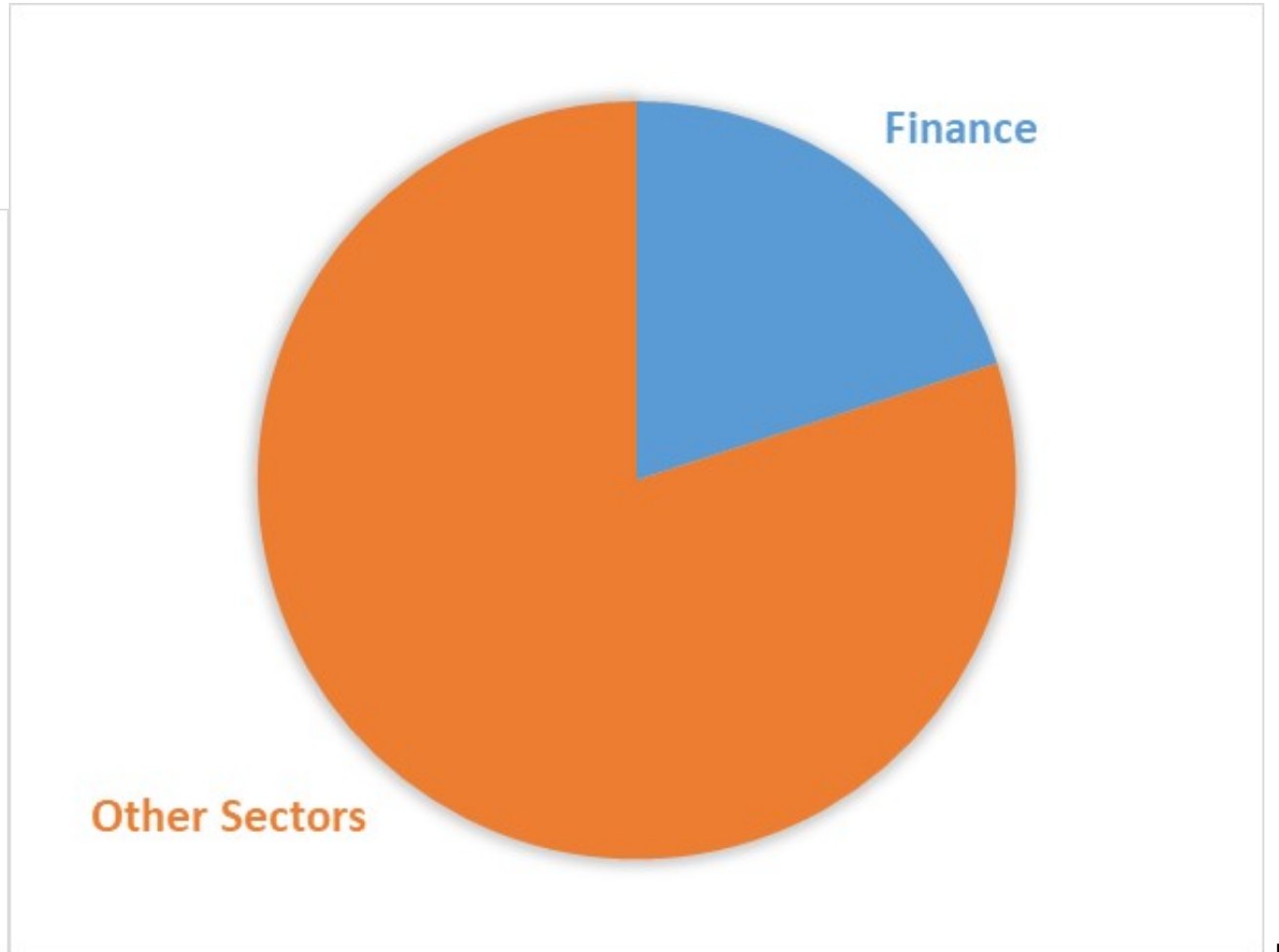
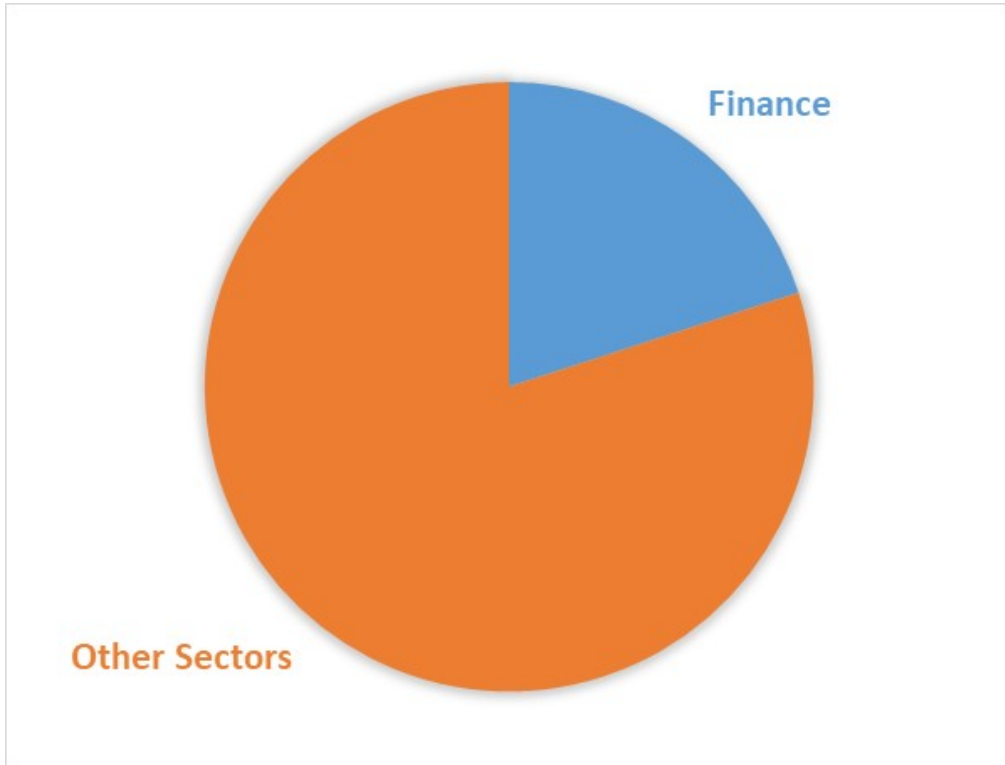
We should caution of course that any estimates of this nature will always be approximations. Other approaches could lead to different results.

In this sense they do merit both further research and the start of a process of more carefully debating and considering the potential social and economic costs of excessive finance in the UK.

Is Finance Pie-Splitting?



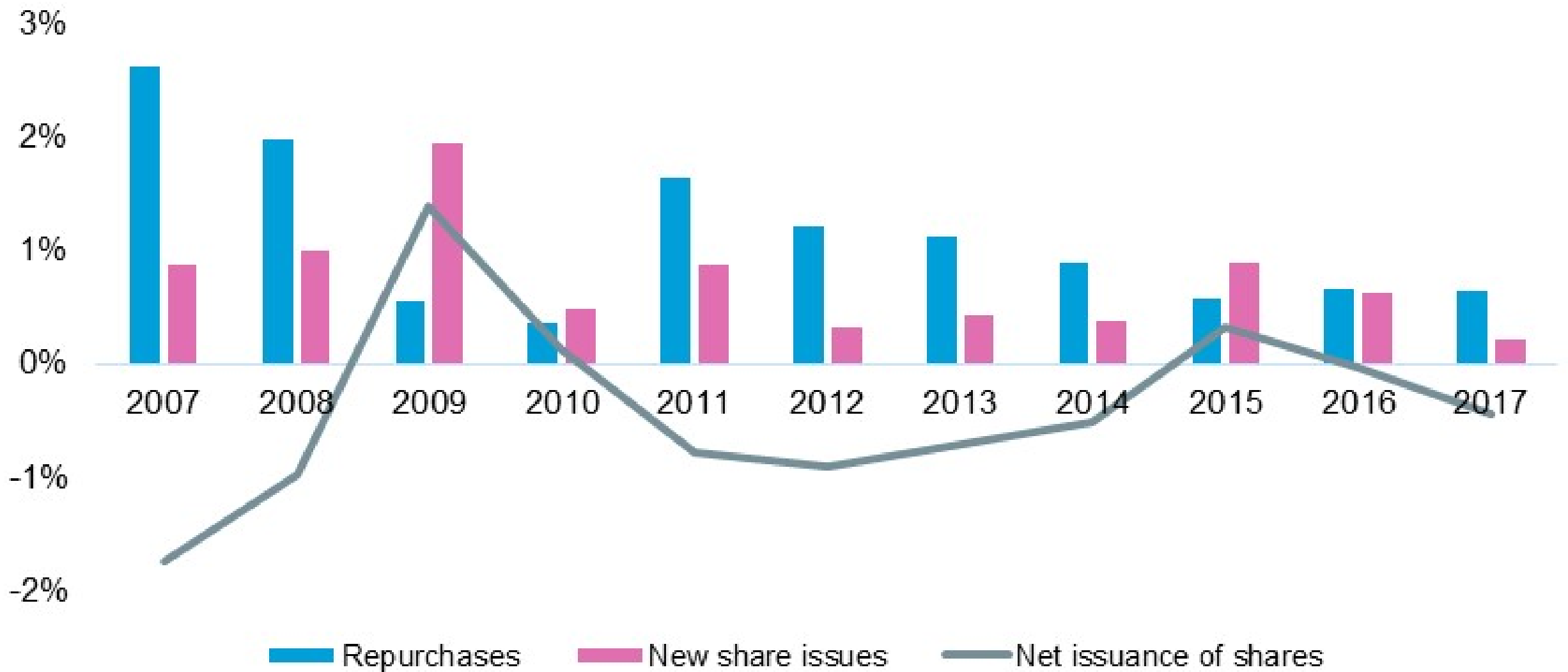
Is Finance Pie-Growing?





Primary Financing Grows the Pie

- Substantial research on
 - Benefits of efficient banking system, primary equity markets
 - Effect of financing on investment (company level)
 - Effect of finance on growth (country level)
- Government policy encourages primary financing
 - Enterprise Investment Scheme, Madelin Provision, INVEST
 - Industrial Strategy White Paper
- But substantial *negative* financing activity

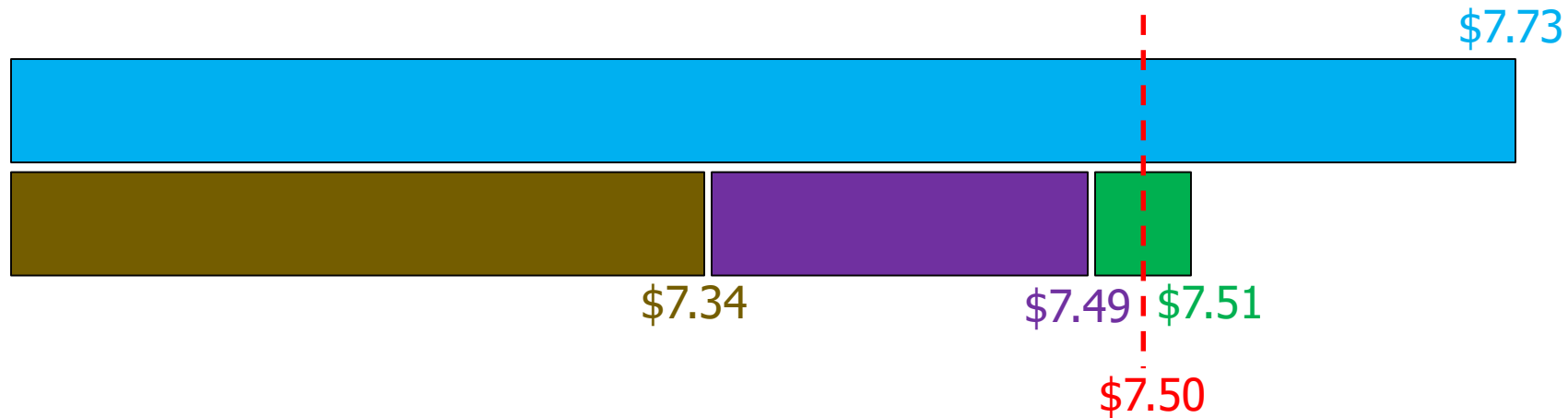




Share Buybacks: The Critiques

- Elizabeth Warren: “stock buybacks create a sugar high for the corporations. It boosts prices in the short run, but the real way to boost the value of a corporation is to invest in the future, and they are not doing that”
- William Lazonick: 91% of net income goes to buybacks and dividends. “That left very little for investments in productive capabilities or higher incomes for employees.”

Humana®



\$1.68 million



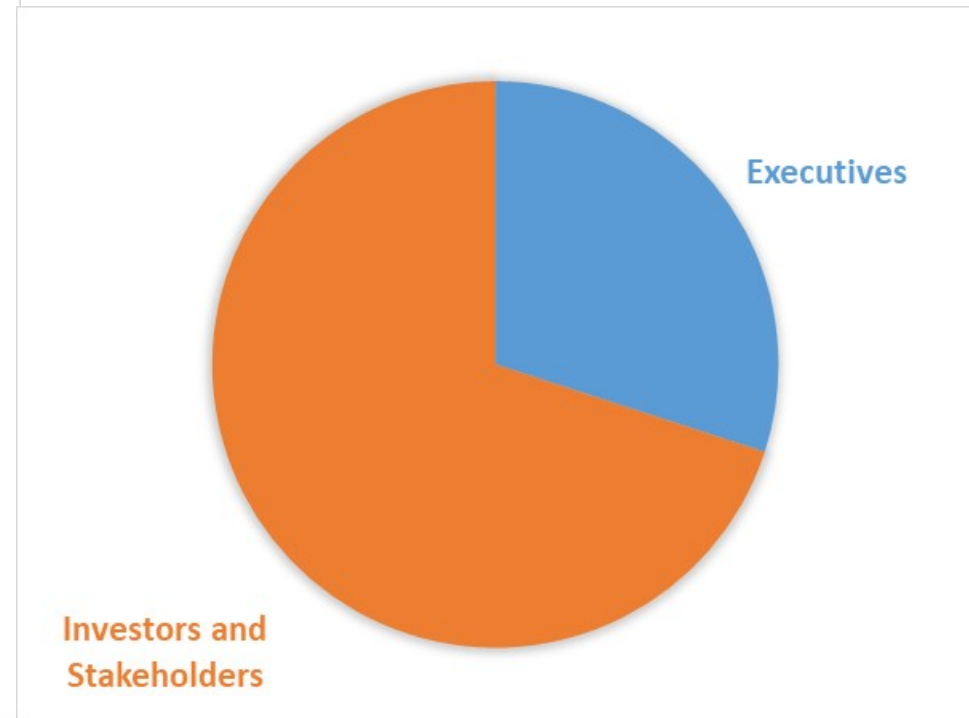
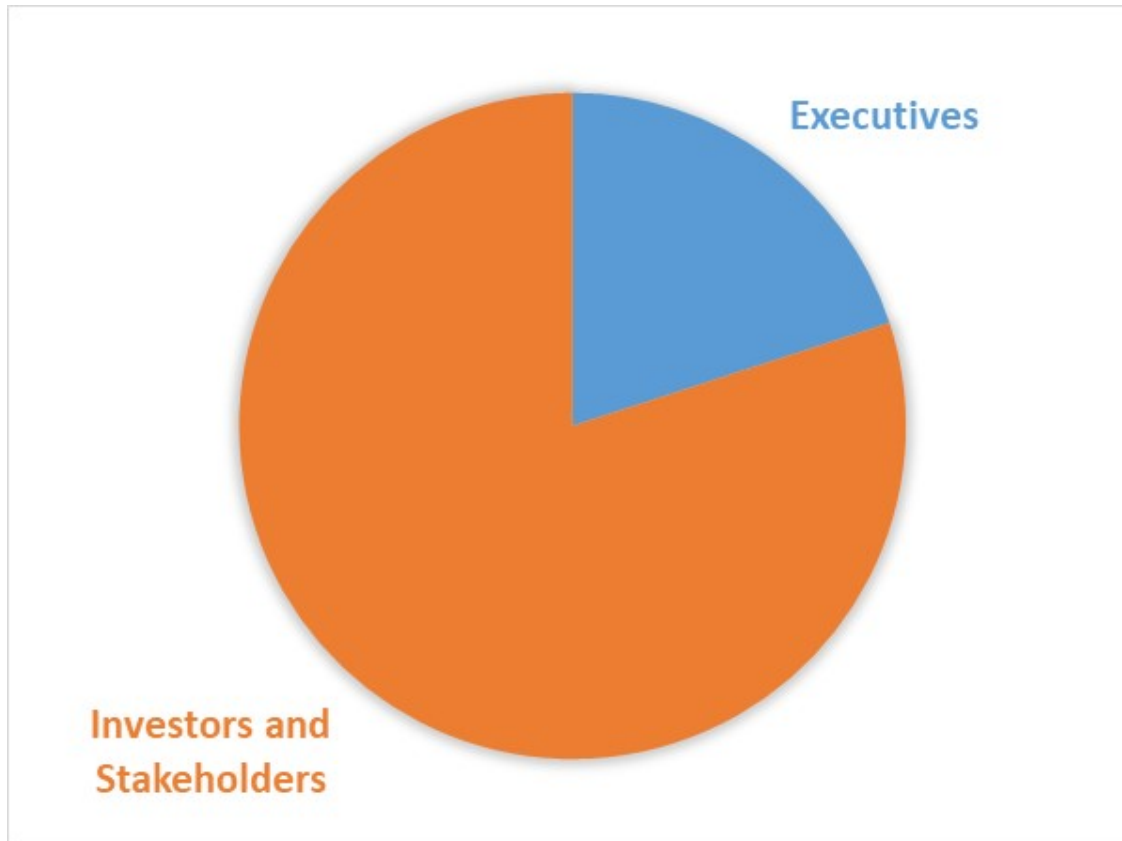
$$\text{Earnings Per Share} = \frac{\text{Earnings}}{\text{Shares}}$$

$$= \frac{\text{Revenues} - \text{Costs}}{\text{Shares}}$$

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Pie-Shrinking Repurchases





The Concerns

- Buybacks are a free gift to investors (“Congress Could Give Bank Shareholders a \$53b Gift”)
- Buybacks are needed for investors to cash out
- 91% of net income goes to buybacks and dividends. “That left very little for investments in productive capabilities or higher incomes for employees.”
- Buybacks aren’t an investment
- Profits should go to stakeholders, not investors



The Concerns (cont'd)

- “The real way to boost the value of a corporation is to invest in the future”
 - Investment only creates social value if social benefit > social cost
- If the CEO who can't think of anything better to do than buy back stock, you've got the wrong CEO
 - Is true if CEO evaluates all investments in purely financial terms
 - A pie-growing CEO will invest more, and buy back less, than a pie-splitting CEO
 - But she'll still use buybacks



The Evidence

- “Stock buybacks create a sugar high for the corporations. It boosts prices in the short run”
 - Boosts prices in the long-run even more (US and global data)
 - Humana buyback netted \$1.68m for Broussard, but \$96m for Humana
- Survey: buybacks come after investment, while dividends come before
- No difference in buyback behavior between companies that just meet or just miss bonus thresholds (in the US)
- The bigger picture: buyback money is reinvested elsewhere
 - Looking at net financing flows is incorrect



How Buybacks Destroy Value

- Vesting equity associated with higher buybacks and lower long-term returns to buybacks
 - CEOs sell equity shortly after buybacks
- Buybacks to meet analyst EPS forecasts lead to lower investment and employment
- Solution: address the root cause of the problem (short-term incentives)



Secondary Financial Markets

- Vast majority of activity occurs in secondary financial markets
 - No new money is raised nor paid out
- But even secondary trading can create value for society
 - Contracting (see Lecture 4)
 - Learning (Hayek)
- Hewlett-Packard – PwC Consulting
- Lucent – Alcatel
- TARP voted down, market fell, Congress U-turn 4-days later
- Quaker Oats – Snapple
 - Stock price fell 10%. Quaker did not change course; lost \$1.4b



The Evidence

- Probability of M&A completion depends on market reaction
- Investment is more sensitive to the stock price when prices are more informative
- Investment is more sensitive to the stock price after insider trading enforcement



Some Finance Harms Society

- Short sellers voting with borrowed stock
 - Can prohibit
- Investors trading on short-term earnings
 - Improve stewardship (Lecture 4)
- Finance companies committing fraud (Wells Fargo), mis-selling PPI, writing sub-prime loans (Countrywide)
 - Lengthen the horizon of executive pay (Lecture 2)
 - Instill purpose and the pie-growing mentality (Lecture 1)
 - Improve corporate governance (Lecture 3)