The Crisis Behind the Crisis

By Kerry Pechter *Mon, Apr 9, 2012*

A new report from Oliver Wyman examines the dysfunctional state of the global financial services industry. It blames asset-liability mismatching for a lot of the trouble, and suggests a return to simpler 'Volkswagen' banking.

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Americans are often scolded for failing to save enough, but an incisive new report from Oliver Wyman faults the financial services industry for the shortage of long-term saving.

The report, “The Real Financial Crisis: Why Financial Intermediation is Failing,” charges that “the financial system is failing in its basic function of intermediating savers and borrowers, especially savers and borrowers with long- term needs.” The report looks not just at the U.S. but also at Europe, India and China.

What most U.S. workers need and want but seldom get is a transparent, trustworthy, low-cost, low-risk plain-vanilla way to save for retirement, the report says:

Our consumer survey shows that there is considerable appetite for a product that would offer a 4% return (average nominal GDP) with a capital guarantee locked for ten years. We challenge the investment industry to invest to develop and deliver this suite of products to clients in a manner which is both profitable for the producer and cost-effective to the client.

Until that happens, the authors expect ordinary consumers to pay a huge price. “The social cost of the current failure of the financial services industry to facilitate long-term saving is in order of 0.75% of GDP, the report said. “In other words, the annual incomes of the next generation of Westerners will be about $15,000 less than they otherwise would be.”

The report argues that financial intermediaries like banks and insurers have bungled the job of matching long-term savers (like consumers) with long-term borrowers (like corporations) through efficient vehicles that minimize the risks and the costs of the transactions for both parties.

Instead, banks have been funding long-term investments (like corporate bonds) with short-term borrowing (like deposits), while insurers have been funding short-term assets with longer-term borrowing.

The “maturity transformation” that these mismatches entail creates unnecessary expense and risk, the report says. Insurers, for instance, have to buy derivatives to mitigate interest rate risk, banks find themselves vulnerable to credit crises that cut off liquidity, and savers don’t get the illiquidity premium that comes from investing in long-term bonds.

Government tax policies don’t help. The mortgage interest deduction and the lack of capital gains tax on home real estate sales, coupled with the “double taxation” of income from bonds purchased with after-tax money, have directed too much savings toward housing and away from corporate bonds, the report says.

Post-financial crisis regulatory developments, such as Basel III and Solvency II, will give financial intermediaries much less room to engage in lucrative but risky maturity transformation, Oliver Wyman believes. Basel III requires banks to back long-term assets with long-term liabilities, while Solvency II applies a mark-to-market regime on insurers.

On aggregate, the report says, the retail investment industry has failed to “deliver reasonable returns.” It accuses the advisory and brokerage community of overstating likely returns, recommending excessive equity allocations, underplaying the risks of investing, churning portfolios to generate fees and drumming up business by advertising unsustainable teaser rates. All of which has damaged the public’s trust in the industry.

As a solution, Oliver Wyman recommends the return of “Volkswagen” banking—low cost, low-risk, transparently priced lending vehicles—to meet the public’s basic need for long-term saving. The consultants also suggest that compulsory saving might be necessary, along with cost-reductions through greater use of technology. As the report put it:

We expect a bigger role for technology, cheaper products and safer institutions. In short, we expect the financial services industry to shift from the pre-crisis model built on leverage to one built on value-added… The shift towards the value-added model is likely to be only partial and slow. Grossly inefficient financial intermediation is likely to persist for the foreseeable future and, with it, the high cost it imposes on society.