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Written evidence given by Professor Alexander Pepper of the London School of Economics and Political Science to the UK Parliamentary Commission on banking standards

WRITTEN EVIDENCE GIVEN BY PROFESSOR ALEXANDER PEPPER OF THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE TO THE UK PARLIAMENTARY COMMISSION ON BANKING STANDARDS[1]

1. This written evidence is provided in support of the oral evidence which I gave to the Parliamentary Commission on Banking Standards on 30th January 2013.

Main argument

2. My contention is that many of the current problems with "Bankers' Pay" have their origins in the dismantling of the formal and informal institutions which regulated the labour markets in the financial centres in London and New York prior to 1986-1987.

Historical evidence

3. On 27th October 1986 a number of radical reforms were implemented in the London financial markets, a series of events which came to be known collectively as "Big Bang". The reforms included the abolition of fixed commissions on share transactions, the ending of the distinction between stock jobbers and stock brokers, changes to the rules preventing foreign ownership of securities firms operating on the London Stock Exchange, and a gradual move from open-outcry to electronic screen-based trading. In the years following Big Bang a series of mergers and acquisitions led to the consolidation of the securities industry into a small number of firms predominately owned by large foreign banks.

4. The reforms were accompanied by a similarly radical change in employment practices in the London financial markets, resulting in a breakdown in the informal labour institutions which had previously regulated employment arrangements. Relatively small closely-held partnerships, where working arrangements were embedded in social networks, were replaced by large universal banks in which employment relationships are primarily governed by formal employment and incentive contracts characterised by a reliance on a cash nexus.

5. Economists have long recognised that labour markets operate very differently from commodity markets. Theories about internal labour markets[2], agency[3] , promotion tournaments[4] and efficiency-wages[5], for example, have fundamentally modified economic explanations of labour market phenomena. Robert Solow, a Nobel Prize winning economist, has gone so far as to describe labour markets as "social institutions"[6] .

6. My thesis is that a system of formal and informal institutions (including social norms) which regulated the labour markets in the London financial sector before Big Bang broke down in the years after 1986. One consequence of this was significant inflation in pay.

7. Before 1986, labour markets in the London securities industry were supported by strong informal institutions. The employment arrangements found in the types of partnerships and closely-held companies which were prevalent in the City of London at the time where characterised by internal labour markets, promotion tournaments and a strong link between risk and reward. There was relatively low staff turnover, a significant jump in earnings only

on becoming a partner, and evidence of real risk bearing e.g., personal bankruptcies, significant losses of family wealth etc.

8. After 1986, the informal employment institutions of the London securities industry rapidly broke down, leading to a highly volatile and unrestrained employment market characterised by high staff turnover, high earnings for junior and middle ranking staff, and breakdown in the relationship between reward and risk

9. Similar changes occurred in working practices in the New York financial markets following the gradually revocation of the Glass-Steagall Act of 1933 after 1987, eventually leading to its ultimate repeal by the Gramm-Leach-Bliley Act of 1999.

What are the policy implications?

10. I am not arguing that history should (or could) be reversed. Nor would it be right to regard the period before Big Bang as some kind of "golden era". My focus is solely on employment markets in the City, which, I am contending, worked well before 1986 and much less well subsequently.

11. I do not believe that technical fixes, such as imposing constraints on the manner and form in which bankers are paid, provide a long-term solution. They are treating the symptoms of the problem, not the cause.

12. I do believe that structural changes in the banking industry, such as those proposed by the Independent Commission on Banking chaired by Sir John Vickers, are necessary to enable necessary changes to occur in the corresponding labour markets.

13. In addition new ways must be found of employing people working in investment banking in order to reinstate a closer relationship between reward and risk.

14. Some have advocated a return to general partnerships as the "employment" model in the securities industry. A better alternative might be to legislate to create a new type of quasi-employment relationship, whereby (1) senior managers, traders and other risk-takers working in the securities industry forgo limitation of liability in respect of activities in which they are directly involved or for which they have responsibility; and (2) are required to put up capital proportionate to their level of earnings.

15. Before any changes are made, it would of course be necessary to have regard to the international position in order to avoid putting the City of London at a significant competitive disadvantage.

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1st February 2013

[1] The Parliamentary Commission on Banking Standards was appointed by both Houses of Parliament in the United Kingdom to report on professional standards and culture of the UK banking sector. It commenced work in September 2012 and published the final report of its findings in June 2013.

[2] Doeringer, P., & Piore, M. (1971). Internal Labor Markets and Manpower Analysis. Heath Lexington

[3] Jensen, M., & Meckling, W. (1976). "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure". Journal of Financial Economics, 3, 305-360

[4] Lazear, E. P., & Rosen, S. (1981). "Rank-Order Tournaments as Optimum Labor Contracts". Journal of Political Economy, 89, 841 – 864

[5] Akerlof, G. (1982). "Labor contracts as partial gift exchange". Quarterly Journal of Economics, 97, 543-569

[6] Solow, R. (1990). "The Labor Market as a Social Institution". Blackwell.