HALLMARK OF FINANCIALIZATION: FINANCIAL PROFITS

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Abstract

Financialization is on the upsurge. Increase in the rate of growth of financial profits is regarded as the main reason behind this upsurge. This paper analyzes the reasons behind the increase in financial profits, examined the sustainability of the growth in financial profits and studied a unique kind of financial profit i.e. capital-gain-like-revenue. It was concluded that growth in the financial profits is exponential, financial profits' rate of growth is even higher than the rate of GDP growth. The detachment between growth rates of financial profits and the GDP can be explained by the capital-gain-like revenues. The share of capital-gain-like revenues is increasing in the financial profits. It was found that capital accumulation is decreasing and profits are increasing because shareholder's preference is profit and not growth, by taking advantage of the shortcomings of accounting rules executives of the bank are overstating profits. When calculating financial profits risk factor has not been properly incorporated in the calculation.

Keywords: Financialization, Financial Profits, GDP Growth, Capital Gain like Revenues, Capital Accumulation.

Introduction

The accumulation pattern, in which profit is generated not through trade and commodity production, but through financial channels is defined as financialisation. There has been an upsurge in financialisation in the recent decades. One reason behind this upsurge is the increase in the rate of growth of financial profits. Financial profits are growing at a much faster pace than non-financial profits. The Even rate of growth of GDP is slower than the rate of growth of financial profits. Because of this ‘profit feature’ of financialisation, we say that profit is becoming the ‘hallmark’ of financialisation. There are various explanations regarding this financial profit. Some explanations say that this growth in financial profit is just an illusion. Financial profits are being overstated because of some weaknesses of accounting rules. Financial profits are overvalued because the risk factor is not been properly calculated. One other explanation says that financialisation is causing financial profits to rise but accumulation to decrease because management is making policies according to the discretion of shareholders and shareholders discretion is just profit-making and not growth, that’s why investment and accumulation are getting decreased. All these explanations will be analyzed in this paper. Some other questions which will be analyzed in the paper are the following: How financial profits are growing faster than GDP? What this financial profit comprises off? Would this growth in financial profits be sustainable? And a unique kind of financial profit i.e. ‘capital-gain-like revenue’ will be analyzed deeply in the paper.
Rise in Financial profits

In the recent decades, there has been an increase in the financial profits. The U.S’s financial sector profit was 13 percent of total domestic profits in 1950-60s, it increased to 32 percent in 2000-11. The U.S’s GDP upsurge by 15 times between 1970-2011 and the profit growth of nonfinancial sector also swung around that trend but the profit of financial sector rose by 28 times from 1970 to 2006. Share of financial income and share of rentier income has gone up. It has risen constantly from 1960s-70s to 1980s-90s. U.K’s rentier income share was 11.48 percent in the 1970s but it increased to 24.5 percent in 1990s. The U.S’s rentier income share increased by 40 percent between these years. And Korean rentier share increased by 7 percent to 15 percent between these years. Amongst 13 OECD countries, 5 countries possessed a downfall in their nonfinancial corporate profit between the 1970s and 1990s. And the rest of the countries experienced a comparatively much smaller rise in their share of non-financial profits as compared to rentier income share between the 1970s and 1990s. The data was examined in both nominal and inflation-adjusted terms and got the same results which are that the rentier income and financial profits have climbed up. The ‘rentier class’ i.e. the people who own financial assets, financialisation is increasing their income.

When the comparing between profits received from the non-financial sector and profits received from financial sector of the US’s economy from 1950 to 2001 was done, used ratio was financial to non-financial profits and it was found that in the 1950s and 1960s, this ratio was stagnant but in 1970s it became unstable. In the 1970s, the ratio rose constantly and in 1980s it climbed up sharply (Fig. 1).

![Figure 1: Ratio of financial to non-financial profits and cash flow in US economy, 1950-2001.](image)

Capital-gain-like revenues

From 1970 to 2011, the US economy’s GDP rose by 15 times but the financial sector profit climbed up by 28 times from 1970 to 2006. The question arises that what is the reason behind this detachment between growth rates of financial profits and GDP? Financial profits climbing up faster than GDP, how is this happening? It was found that a unique type of profit which is capital-gain-like-revenue is the reason behind this detachment between growth rates of financial profits and GDP. Capital-gain-like revenues (Bank holding companies, BHC’s) comprises of three types of profits, total securitization income, founder’s profit, and realized capital gains. Net fees from servicing, net income from securitization and net gains (losses) on sales of loans and leases, comes under the category of total securitization income. Founder’s profit comprises of underwriting fees, gains from mergers and acquisitions (M&A) and fees from investment-banking-like activities, including IPOs. The category of realized capital gains includes the following: available-for-sale securities’ realized gains (losses), held-to-maturity securities’ realized gains (losses) and revenue from trading.

The share of capital-gain-like revenues is raising in the total share of financial profits. The data of profits of bank holding companies (BHC’s) of the U.S was examined, BHC’s profits can decode the general spin of the U.S financial profits because of the whole U.S’s financial sector, BHC’s are quite representative and BHC’s profits have a considerable portion of the total financial profits. It was found that the share of the income received from traditional banking businesses in the total revenues of BHC’s is shrinking and the share of non-interest income is magnifying. From 1986 to 2005, total non-interest income rose from $36 billion to $401 billion. In 1986 non-interest income share in total revenues of BHC’s was 15 percent.
and it magnified up to 38 percent until 2003. In 2010, non-interest income portion was 50 percent in total revenues of BHC’s. In other words, we can say that 50 percent of BHC revenue was coming from non-interest income.

Non-interest income includes revenue from trading, revenue from venture capital, fiduciary activities income, commissions and fees from insurance, deposit accounts service charges, investment banking fees, net income from securitization, net fees from servicing, and net gains on sales of various assets. In these non-interest incomes, the income which is getting prominent is capital-gain-like revenues. Its prominence will get clear from the fact that, out of total the U.S BHC’s non-interest income, about 40 percent comes from capital-gain-like revenues. The capital-gain-like revenues share has magnified after the crisis.

This capital-gain-like revenue is the factor behind the disconnection of the rate of growth of financial profits and the rate of growth of GDP. This capital-gain-like revenue possesses some unique kind of characteristics because of whom we are seeing this disconnection between them. Between, 2001 to 2010 about 50% of the disconnection between the two was because of capital-gain-like revenues. Capital-gain-like revenues come from the redistribution of the stocks of monetary assets and in the current GDP they do not have any counterpart, that's why it is not surprising that the rate of growth of capital gain like revenues of BHC’s is different from the rate of growth of GDP. And this is also the reason behind the speedy recovery and considerable increase in profits at the recession’s time.

When GDP growth is slow then also but a portion of capital assets still exists which can still be redistributed even in recession’s time. Capital-gain-like revenues are of positive-sum like nature i.e. when the transaction of capital assets takes place then, the seller of the asset gets the profit which cannot be taken away from him and the buyer of the asset gets a claim on the future incomes, which gives positive return on investment, and because of this nature of capital-gain-like revenues the capital assets transactions become sustainable. We can say that the positive-sum character of financial assets has the capacity to explain that how these profits become sustainable for a considerable time period. Another unique kind of characteristic of capital-gain-like revenues is that the losses in the transactions of capital assets are not borne by the seller because the seller has got the gain and its gain has got 'locked in' and the loss in these types of transactions is borne by the ultimate buyer. So we can say that the capital gain like revenues doesn’t have to be offset by the subsequent losses of the profit recipient.

**Profits are increasing but accumulation is decreasing**

Work was done on the theory which says that, because of financialisation, accumulation is getting slower. He argued that the growth rate which is required by the firms is getting decreased because of 'revolution of shareholder' i.e. markets are evolving for corporate/shareholder control and the management’s priority is shifting from increasing the growth to increasing the shareholder value. Due to this, management is busy in maximizing profits because they are working for shareholders and shareholders are only interested in profits and not in anything else. But for a manager maximizing profit should not be the only aim, he has many other duties, as well, and firm growth is one of them. Shareholders/corporate have the power to fire managers, they have control over pay schemes, etc. Because of these powers of shareholders/corporate, management adopt such policies which fulfill the desires of shareholders, and shareholders desire is earning the profit, that's why management make policies of the firm in such a way that profits get increased, and it forgets about the growth of the firm, investment and everything else. Because of this, we are seeing a slowdown in investment activity and hence, stagnation in accumulation.

After doing some empirical tests for the Germany's, France's and the USA's business sector with annual data. The results of the tests which came prove that his hypothesis was quite right, financialisation was the reason behind deceleration in the accumulation in France and the USA. But Germany’s tests proved his hypothesis wrong and UK’s findings only showed some endorsement of the hypothesis. In the golden age, UK already saw low accumulation rates, that's why despite financialisation, UK didn't show the general slowdown in accumulation. And Germany didn't show findings according to the hypothesis because Germany's condition is quite different, this concept of 'shareholder value orientation’ is very new. Because of financialisation, about 33 percent of the deceleration in accumulation was experienced by the USA and in France entire deceleration in accumulation was experienced due to financialisation.
Illusory financial profits due to shortcomings of accounting rules

One other explanation of financial profits is illusory financial profits. Excess financial profits are been reported because of the shortcomings of accounting. Bank employees are able to overstate their profits due to some recent shortcomings of accounting came after some changes made after the crisis. Bank people exaggerate their profits because by doing this, they earn for their shareholders, some short-term gains and for themselves, bonuses. Avoiding misallocations of capital and cheating is the duty of accounting rules which they are failing to perform. Bank’s major role in the allocation of capital throughout the economy, bank’s inter-dependence in finance, and Bank’s large scale of assets, these three reasons make accounting failure much more considerable in the banking industry as compared to other industries. The accounting rules and regulations which were made in the reaction of the crisis, are helping executives in overstating their profits. Rules and regulations were made for some different motives but they are doing something else, which is not good for the economy. Many problems are there in the rules governing capital reporting and bank profit which helps executives in overstating the profits.

The 5 of those problems are as follows: 1. by purchasing a credit default swap (CDS) or some similar ‘safety’, doubtful future cash flows can be admitted as not doubtful, in spite of the fact that if the insured event happens then the supplier of the safety will probably default. 2. On the market price basis, from the lowered value of liabilities or from the enhanced value of assets, profits can be recognized, in spite of the fact that the price at which the assets or liabilities are revalued, they couldn't be sold at that price. 3. Mark-to-model valuation approach, profits can be admitted from the enhanced value of assets and lowered value of the liabilities, on the basis of the model constructed by bank people, even when the revaluation of assets is evaluated not by market prices. 4. Even when their estimation is been done using doubtfully optimistic forecasts, the net present value of doubtful cash flows can be admitted as profits. 5. Banks have been given the liberty by the regulatory that while estimating their profit they need not make provision for expected losses. In different transactions bankers use these accounting rules and achieve their motive of inflating profits. By inflating profits, they turn funds of taxpayers, funds of debt-holders and equity of shareholders into bonuses of executives.

Exaggeration in profits due to undervaluation of risk:

One other explanation of financial sector profit suggests that the financial sector profit which is growing at a very high rate wouldn't be that higher if they would have been properly adjusted for risk. If a detailed decomposition of banking return will be done then we will find that various risk-taking strategies are used which generates excess returns for staff and bank shareholders. Higher trading profits, leverage and investments in deep-out-of-the-money options are some risk-taking strategies which are used to proliferate excess profits. If these risks got materialized then profits of banks will get reduced to a large extent. To find out the true value added by the financial sector, there is a need to discover improved ways of measurement of risk. There is a need to develop a sophisticated approach to measure the true value of return and to measure risk accurately. If the risk is measured inaccurately and it is undervalued then it would lead to an overvaluation of the contribution of banks to the economy. Bank specific performance measures and better aggregate statistics can help in the true valuation of risks incurred by the banks and can help in the true valuation of financial profits. Risk is undervalued by the banks not by accident but by planned design. Because it is in the interest of bank managers to overvalue their profits and undervalue risk. Risk strategies only work there where the regulations are weak. And it is quite difficult for the regulators to make regulations which can choke risk strategies because regulations also have their natural limits. But still regulators should make regulations quiet cautiously so can these risk strategies can be blocked at least to some extent, otherwise, that wouldn't be good for the economy.

One other problem with the risk valuation is that there is the absence of reliable data in some of the financial activities. These some activities comprises of the activities in which the returns are apparently high. And the questions which remain unanswered regarding this kind of activities are, how much risks this kind of activities incarnate, and in the markets in which they are traded, how competitive these markets are? Competition authorities and regulators should workout to find the answers to these questions, so that true value of financial profits can be estimated.

Conclusion

In this paper, we saw that how the growth rate of financial profits is climbing up. Their growth is even more than the growth of the GDP and capital-gain-like revenues have the potential to explain this detachment between the growth rate of
GDP and growth rate of financial profits. Prominence and share of capital gain like revenues are increasing in the total share of financial profits. And because of some unique kind of features of capital gain like revenues we are seeing this detachment between growth rates of GDP and financial profits. Because of 'shareholder revolution', management is making policies according to the preferences of shareholders and shareholder’s preference is profit and not growth, that's why accumulation is decelerating and profits are climbing up. Increase in the growth rate of financial profit is just illusion. Bank executives are overstating profits with the help of some shortcomings of accounting rules, so as to get more bonuses. Risk has not been properly calculated that's why we are seeing this upsurge in the growth rate of financial profits if the risk factor is been properly analyzed than financial profits will not show that much growth.

It is quite clear that prominence of capital gain like revenues is increasing in financial profits, and facts are showing that financial profits are also growing quickly but I have some doubt in their sustainability. If accumulation will get decelerated than the sustainability of financial profits will get hindered at some point of time. And the issues like increase in financial profits because of shortcomings of accounting rules and because of undervaluation of risk should be given attention.

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