The Need for Policy Focused Finance Research

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Abstract

A shift in the focus of finance research is needed so that it can benefit society. Practitioner-oriented journals should take the lead by proactively asking academics and practitioners to identify topics that address nascent challenges facing the financial system and invite them and policy-makers to submit articles that shed light on the issues and recommend solutions. A proposal worth considering is to tie senior management compensation to the need for financial infusions by taxpayers in the event of systemic failures induced by excessive and fraudulent risk-taking. In such cases, the penalties imposed on management would involve a clawback of past and present compensation.

Nobel Laureate economist Robert Shiller believes that the finance industry can be harnessed to benefit all of society and that changes and innovation in the finance industry can make the world a better place.[1] He states that many participants in the industry such as bankers, investment managers, CEOs and educators can play an active role in improving the system. But conspicuously absent is any discussion of the role that academic research can play in improving the financial system.

This lack of relevance is reflected in public opinion which believes that academic research is neither innovative nor engaging, and does not benefit society. About 50 percent of academic papers are read only by journal editors and 90 percent are never cited, implying that their findings are of limited use.[2] The Rutgers Business School (RBS) General Impact Index for business journals, which measures the extent to which academic business journals contribute to the knowledge base of the business world finds that most journals including finance journals, have low impact scores.[3] It seems imperative then that there is a need for a shift in the focus of finance research so that it delivers benefits to society.

In keeping with their mission of appealing to industry and policy makers, practitioner-oriented journals should proactively ask academic researchers and practitioners to identify topics that address nascent challenges facing the financial system and invite them and policy-makers to submit articles that shed light on the issues and recommend solutions. These articles would be published after being vetted via the referee process. Readers should be encouraged to weigh in on these articles, with cogent responses published in subsequent issues of the journals (or online to be quicker) to broaden the discussion. Subsequently, they should be disseminated to policy-makers in Washington and to business media outlets such as *Bloomberg News* to widen the discussion.

The introduction of such articles will broaden the appeal of the journals because readers are interested in articles that are forward-looking and relevant to addressing the issues and challenges facing the system. Although the *Wall Street Journal* publishes such articles on its editorial page, they have not been vetted by referees and often have a political ax to grind.

The insights gleaned from empirical analysis are limited when addressing policy-oriented issues because they present an understanding of the past, which often is not replicated in the future. Analyzing the past and basing decisions on past experience relegates us to fighting yesterdays' battles. Academic research is beholden to empirical testing because of the rigor of the process. But academic rigor is not the be-all and end-all in explaining how the world will work in the future, specifically in areas in which the ever-changing and adapting human psyche determines the outcome, i.e. economics and finance. Empirical research has other limitations too. *The Economist* pointed out that a significant failing within the economics profession was its inability to anticipate the financial crisis that commenced in 2007.[4] The article goes on to state that empirical methodologies have their limitations because they cannot account for social and political factors.

Events that lead to crises in financial markets are rarely duplicated. For instance, the real estate bubble of the 1980s was triggered by the savings and loans industry's lax lending standards for commercial properties.[5] In contrast, the real estate bubble of the previous decade was triggered by lax (and fraudulent) lending standards for residential properties and was aided and abetted by a lack of due diligence from the bond rating companies. Prior to 2008 there was little discussion in any publication about questionable collateralized mortgage obligation (CMO) bond ratings and their potential for creating an asset bubble. Chances are that the source of future financial contagions will not be anticipated and the existing set of regulations – which are being watered down as we speak – will be inadequate to address holes in the regulatory framework. A recent article in *The Economist* speculates that excessive levels of corporate debt could well be the source of the next financial crisis.[6]

So is it possible to develop a set of regulations that are impervious to a dynamic and ever-changing financial system which finds new ways to bypass regulations as was the shadow banking system prior to the 2007-08 financial collapse? A proposal worth considering is to tie senior management compensation to the need for government intervention in the event of systemic failures induced by excessive and fraudulent risk-taking. According to a former hedge fund manager and trader, senior management should not enjoy the rewards of their actions but transfer the downside (risks) to taxpayers.[7] That is, you cannot get rich without owning your own risk and paying for your own losses, which he refers to as having skin in the game.[8] Forcing skin in the game balances this asymmetry better than the roughly 2300 pages of regulations that are the Dodd-Frank act.[9] In the event of systemic financial institution failures caused by irresponsible risk taking requiring taxpayer-financed infusions, the penalties imposed on management would be severe enough not only to clawback past and present compensation but possibly to confiscate some of the accumulated wealth (investment earnings on past compensation) of the risk-takers.[10]

Would such a radical regulatory change be sufficient to incentivize managers to act responsibly? Developing the architecture of a complex and presumably highly contentious plan will require serious thought and vetting of proposals. The devil will be in the details of such a plan and will have to anticipate and account for unintended consequences. So it would be fruitful for some of the best academic minds studying manager compensation to lend their considerable expertise to devise a plan that would temper excessive risk.

The possible outcome of such an effort could well be for naught. Giving up limited liability protection for managers will be fought tooth and nail by them and their lobbyists. Congress conveniently finding the proposals too bold and far reaching, and egged on by special interests, could scuttle proposed legislation. At the very least, such an exercise will stimulate discussions in business forums, academia, and media outlets and when (not if) another financial calamity strikes, taxpayer ire would be sufficient to pressure congress to enact bold legislation.

The phrase "Not everything that counts can be counted; not everything that can be counted counts," is appropriately the raison d'être for such endeavors.[11] Because some of the articles do not pass the academic rigor test does not diminish their relevance. In fact, there is need for conceptual thought that address the challenges facing the industry. The measure of an articles worth should be determined by it virtuous impact rather than its mathematical or empirical complexity. Universities should do their part by recognizing academic authors' policy-oriented contributions that benefit the economy. Tenured and seasoned faculty should be evaluated and compensated for their contributions to such endeavors.

This recommendation is in keeping with efforts to make finance research useful to the public and taxpayers who subsidize research at state universities. Inviting articles that identify and address asymmetries in the financial ecosystem as outlined here would broaden the scope of contributors, introduce new ideas, stimulate discussion and at the end of the day benefit society.

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Murad Antia is a senior instructor at the Muma College of Business at the University of South Florida, Tampa. He teaches financial statement analysis and works with some of the college's top scholars. He has received the Outstanding Research Award for Instructors for five consecutive years. He has published articles in the Financial Analysts Journal, the Journal of Investing, the Journal of Financial Research, the Journal of Corporate Finance and the Journal of Multinational Financial Management, among others. He has also reviewed books for the Financial Analyst Journal. Prior to his academic career, Mr. Antia was a Senior V.P. at Amsouth Bank (now Regions Bank) and Barnett Bank (now Bank of America) where he was an investment manager for the banks' investment clients. Dr. Antia earned a PhD from the University of Houston, an MBA from Duke University and a B.S. from the Elphinstone College at the University of Bombay.
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Endnotes

1. Shiller, R. (2012). *Finance and the Good Society*. Princeton, NJ: Princeton University Press.
2. Roos, J., Mellander, C., & Danielsson, E. (2016, May 1). Turning academic research into public engagement. *BizEd*.
3. Yayla, S., Kutlubay, O., & Yeniyurt, S. (Fall 2016). The Rutgers Business School General Impact Index for Business Journals. *Rutgers Business Review*, *1*(1), 140-145.
4. Economists understand little about the causes of growth. (2018, May 5). *The Economist*.
5. Reagor, C. (2009, February 8). Can we learn from '80s crash? *The Arizona Republic*, retrieved from AZCentral.com.
6. Corporate debt could be the culprit. (2018, April 14). *The Economist*.
7. Taleb, N. (2018). *Skin in the Game: Hidden Asymmetries in Daily Life*. New York, NY: Random House.
8. To have "skin in the game" is to have a personal stake by incurring personal risk (monetary or otherwise) in achieving a goal.
9. The intent of the Dodd-Frank Wall Street Reform and Consumer Protection Acts' is to decrease various risks in the U.S. financial system. The act created a number of new government agencies tasked with overseeing various components of the act and by extension various aspects of the banking system.

10. A clawback provision is a contractual clause included in employment contracts, by which past compensation must be paid back under certain conditions such as fraud and accounting errors.
11. Cameron, W. (1963). *Informal Sociology: A Casual Introduction to Sociological Thinking*. New York, NY: Random House.