

RESEARCHBUZZ

Are Returns to Capital Hitting New Historic Highs?

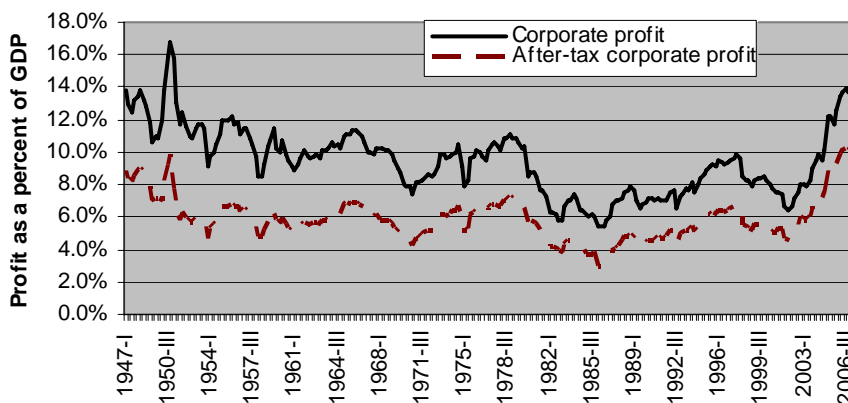
BY DR. JOHN A. TATOM

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Some analysts believe that earnings of owners of capital are booming, setting new records. The basis of this view is that corporate profits, both before and after taxes, have been climbing in recent years as a percent of GDP. This has contributed to the view that workers are falling behind as the share of compensation declines, reflecting the rising share going to owners of corporate capital.

Chart 1 shows that corporate profit, which is actually a return to capital and risk taking, has risen sharply. In late 2001, this share was only 6.4 percent of GDP, but by the end of 2006 it had more than doubled to 13.8 percent, a share not seen since early 1951. After-tax corporate profit shows the same sharp acceleration and to a level not seen in the historical record, since corporate tax is a smaller share of GDP than in 1947-51.

Chart 1: Corporate profit has boomed recently



Thus, it appears plausible that the return to capital and its share in GDP are unusually high, which would imply that the share of labor compensation is unusually low.

The difficulty with this conclusion is that corporate profit is not the only payment to owners of capital. Interest, rent and profit of unincorporated business are also payments for the services of capital. In addition, in assessing corporate income as a share of GDP it is important to account for the fact that GDP is “gross.” To maintain comparability, consumption of fixed capital should be added to the numerator as well. After all, the gross return to capital includes the cash flow from “true,” as opposed to accounting, depreciation. The sum of these components as a share of GDP is called capital income in Chart 2 and is measured relative to GDP. This is plotted in the second chart along with an economic measure of the gross corporate income owned by stockholders, which equals after-tax corporate profits (with inventory valuation capital consumption adjustments) plus corporate consumption of fixed capital. This is referred to as adjusted after-tax gross corporate income in the Chart 2. The third measure shown in the chart is the economic measure of after-tax corporate profits, which is gross corporate income, after tax, less consumption of fixed capital. It is the correct measure of corporate capital income that can

be compared with the after-tax “accounting” measure show in Chart1.

The adjustments for inventory and capital consumption take into account that firms over-report or under-report the cost of depreciation and inventory due to accounting rules that they are forced or choose to use. As a result, corporate profits are either

under- or overstated, respectively, and that will reduce or raise the tax burden, consequently over- or understating the after-tax economic measure of profit. Adding in an estimate of “true economic depreciation,” or consumption of fixed capital, results in a gross measure of the after-tax income of corporate capital. Thus, this is a better measure of the earnings that are owned and therefore discounted by stockholders.

The top line in Chart 2 shows that gross capital income has not changed much in recent years. It has risen as a share of GDP since the recession in 2001, but not unusually so, especially compared with its past history. There is a sharp drop in the historical series from early 1966 to early 1970 that makes gross capital income deviate from a constant, but this decline and earlier ones reflect a sharp decline in the size of business sector output relative to GDP over the earlier period, as the size of government surged relative to the size in the private sector. The shares of labor compensation and capital income relative to income or output in the business sector, about 80 percent of the economy, are remarkably constant over time. When government compensation of labor, the principal measure of government sector, is added to business sector compensation and GDP, the ratio of total compensation as a per-

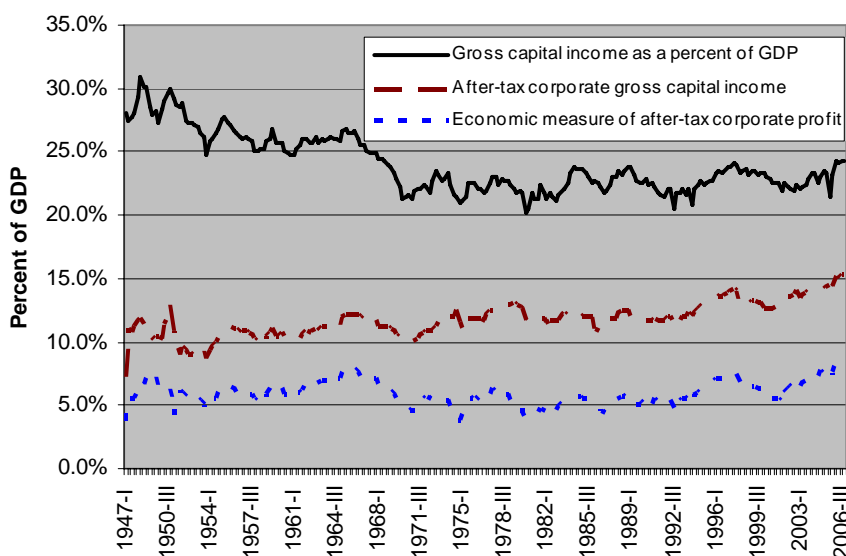
cent of GDP rises, and its counterpart, the share of capital income, falls.

From 1947 to 1961, the share of business sector output fell from about 84 percent of GDP to about 79.5 percent in 1961 to 1967 and then fell sharply, reaching about 77 percent by 1970. The latter shift is especially apparent in the fall of the share of capital income shown in the top line in Chart 2. Except for variations in the share of the business sector in GDP, the share of capital income, and its counterpart share of compensation, would essentially fluctuate around a constant. This is the case after 1970, including recently. Thus, the share of overall capital income does not show any unusual rise recently, just as the share of compensation has not declined unusually relative to its past performance. This is in strong contrast to claims by some that the share of capital income has climbed recently at the expense of the share of labor compensation.

The principal reason that corporate capital income has remained steady relative to GDP while corporate capital income has risen sharply, is that proprietors’ income, rent and especially interest have been relatively weak or declined. In effect, lower interest rates have lowered interest costs and boosted corporate profit without changing the overall share of capital income in GDP. The comparable share of after-tax gross corporate capital in-

come is shown in the middle line in Chart 2. There has been a rise in gross corporate income relative to GDP, but not nearly so sharp a rise as suggested in Chart 1. In fact since early 2001, after-tax gross corporate income has risen about 3.4 percent of GDP, much less than the 7.6 percent rise in total corporate profit, measured on an accounting basis, shown in Chart 1. In the bottom line, the share of after-tax corporate profit, adjusted for profits from understating depreciation or from in-

Chart 2: Capital income is not booming, but corporate income is



ventory accounting gains, rose only 3.1 percent over the same period. While this is an impressive gain, it leaves correctly measured corporate profits at a relatively high level, but only in record territory in 2006, compared with earlier peaks in 1965 and 1997. Until 2005 it would be hard to argue that after-tax corporate profits, with adjustments, had reached an unusual level relative to GDP. The extra strength in the gross and accounting measures (Chart 1) arises from a rise in corporate depreciation and taxes relative to GDP.

So, has the return to capital reached unprecedented levels in recent years, supporting the notion of declining worker compensation relative to GDP? No, these shares have been in line with past trends. Nonetheless, it is the case that accounting measures of corporate profit have shown unusual growth over the past 5 years, reaching levels not seen in over 50 years. Adjusted for depreciation underreporting and inventory gains and increases in corporate income taxes relative to GDP, corporate income has not been so strong. It has risen to historic highs, but only in 2006.

A simple accounting of differences shown in the charts reveals the source of the discrepancy between the rise in measured profit and overall capital income as shares of GDP from the end of 2001 to the end of 2006. Over the period, the 7.3 percent rise in accounting profits relative to GDP has been associated with a rise of 2.7 percent of GDP due to the swing to underreporting of true economic depreciation, 1.7 percent rise in taxes relative to GDP, and 0.7 percent rise in true economic depreciation of corporate capital, called consumption of fixed corporate capital. The net result is a rise in after-tax gross corporate income of 2.0 percent of GDP. Overall gross capital income rose only 1.7 percent of GDP over the same period.

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Book Summary: All You Need to Know about Ethics and Finance

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A *All You Need to Know about Ethics and Finance* (2007), by John Plender and Avinash D. Persaud, is a book about business ethics written for financial services professionals. Plender is a senior editorial writer and *Financial Times* columnist since 1981 and Persaud is currently President of Intelligence Capital Limited, a financial advisory boutique specializing in the management of liquidity, risk and investment portfolios. Persaud has previously held positions with GAM London Limited, State Street Bank and Trust, J.P. Morgan and Union Bank of Switzerland. The book is made available by Britain's Longtail Publishing, as part of their "All You Need to Know" series. The authors maintain that they wanted to write a practical text to help professionals make ethical decisions in the real world, rather than to simply write another philosophical treatise. Plender and Persaud argue that professionals should not outsource ethical decision-making to others, such as lawyers and compliance officers.

The book is divided into four main parts. The first part, "Finding a Moral Compass," glances over the wide array of academic literature on the subjects of ethics, corporate social responsibility, and socially responsible investment and examines how companies and regulators have embraced these concepts. However, all of this activity has failed to do much to change views of or improve ethics in the market. Indeed, ethical lapses have occurred during a time when laws were the most stringent they have ever been. The authors observe that the greater the numbers of laws, the more professionals are tempted to focus narrowly on compliance. To be ethical, exclusive reliance on the law is not enough. Plender and Persaud argue that business schools are partly to blame for the failure of the ethics movement. Instead of simply creating a course for business ethics, the authors advocate

the inclusion of ethics across the business curriculum.

Plender and Persaud provide three main reasons for the recent decline in ethics. First, the requirement for quarterly reporting has created a “hitting the numbers” culture. Second, the growing adoption of performance-related, equity-type incentives has also led to a decline in business ethics. Third, as the professions of accounting and law moved toward a more free market orientation for performance evaluation, this change slowly led to a decline in ethics. The authors do stress that business ethics is not a lost cause and should be a continuing high priority because trust is vital in business relationships. Finally the authors maintain that too often financial institutions mis-sell or “rip off” their customers, and when they are eventually fined, they pass the costs off to their shareholders and customers. Financial institutions that engage in mis-selling activities rarely go out of business.

The book’s first section covers many ethical dilemmas, how ethics are viewed in various economies, and how ethical values can change over time. The authors discuss how global ethics has shown that values such as truth, compassion, responsibility, freedom, as well as reverence for life and business are very important to a majority of the people in all nations. However, the same is not true of values in a business context. The authors suggest asking, “Am I putting my own interests and the interests of the firm ahead of my client?”

The second part of the book concerns corporate behavior and governance. Plender and Persaud examine ethical issues in a variety of specific scenarios, including mutual funds, mis-selling, distinctions between law and ethics in speculation, creative accounting, tax avoidance, whistleblowing and independent directorships. The authors stress that everyone cannot be treated the same when buying financial services because some people are significantly more experienced with the mar-

ket than others. Regarding the practice of mis-selling (ripping off investors), for example, and how regulation has failed to curtail this practice, the authors cite a number of scandals in which individuals incurred investment losses. Plender and Persaud maintain that this result is not necessarily the result of unscrupulous activity by financial service providers. However, if sellers are offered bonuses for short term performance, they will ultimately put their own interests above others. In addition, without effective penalties for wrongdoing or effective regulation, unethical behavior is likely to continue to flourish.

All You Need to Know about Ethics and Finance examines speculating. It asks, if the law is always reactive, why should we expect more from financiers than legal behavior? Persaud and Plender discuss short selling, or investors selling more of a stock than they own, expecting that they will be able to buy it at a cheaper price later. Short selling is not illegal, but is it unethical? The authors maintain that it can become so when the short seller is attempting to reduce the value of the stock in a way that would not have occurred otherwise. The authors provide an ethical framework for speculators, the aim of which is the imposition of higher ethical standards, which leads to a more inclusive financial system. Ethical guidelines should be simple to use and focused.

Despite being ethically questionable, the U.S. capital market approach to creative accounting is being adopted around the world. A major problem with this approach is that CEOs in the United States create the benchmarks by which they are evaluated. The authors go on to discuss that a very basic question managers should ask in relation to “smoothing the numbers” in accounting concerns the failure to be open with shareholders about earnings manipulation. Management should tell it like it is unless this would cause measurable damage to the

stakeholders. Similarly, numerous ethical issues are associated with tax avoidance. Because managers have an obligation to maximize shareholder value as well as an obligation to ensure the firm pays its taxes legally, they face a major conflict of interest. The authors go on to discuss that an aggressive strategy of tax avoidance can create a major risk to the firm's reputation.

The book's third section, "External Scrutiny," looks at ethical issues for groups that are external to firms, focusing on ethics for bankers and advisors, auditors, analysts, and regulators. Bankers and advisors must understand that the legal interpretations of their actions can change depending on whether the market is in a boom or a bust. The ethical concerns do not change, however. Auditors must address important questions that go beyond mere compliance. During the 1990s, auditing had been pushed back as a low growth activity, as non-auditing work became more important for auditing firms. As economist John Key stated, "If burglars hire the police, policing strategies will suit the burglars." The authors go on to discuss how the largest accounting firms have essentially franchised their brand names and therefore don't have the ability to enforce consistent auditing standards around the world. Because of the recent scandals however, the authors maintain that auditing has become less of an "orphan" business.

Conflicts of interest represent the largest number of ethical issues that analysts face, and these conflicts can create biased analysis. Because of this, the capacity for analysts to create disguises for unethical behavior is limited. Many financial professionals maintain that one must adjust for biased analyses, but one cannot adjust for bias without being aware of it. The authors maintain that even being aware of bias in analysis does not guarantee that people will be able to adjust for it.

Plender and Persaud stress that ethics cannot be outsourced, and that an ethical cul-

ture must start with individual responsibility. This means that firms should be open to questioning and changing their behavior in response to the ethical concerns of their various stakeholders. Even at firms that understand the importance of ethics, the rate of change with corporate takeovers makes it increasingly difficult to hold onto core values.

While their volume is effective in providing examples of ethical lapses in various countries tied directly to important points about ethics in business, differences in ethical concepts from various countries, and examples of ethical lapses at various firms, are less effectively examined. This is unfortunate because it limits the discussion of many ethical business concepts including whistleblowing, corporate governance, and how directors, bankers, and advisors view ethics in the real world. *All You Need to Know about Ethics and Finance* further lacks a thorough discussion of how to group and then manage a firm's various stakeholders. This is a basic concept of strategic ethical decision making, and it is an area that the authors should address in future editions of this text.

That said, the book is a very good read for financial service professionals who are striving to be more ethical and a practical guide, though readers may want more information of certain topics. The ethical questions that professionals should ask when confronted with an ethical dilemma serve as effective guides. These very useful questions are listed at the end of each chapter, cover numerous general ethical issues and should be considered a must read for financial professionals. By using this book, professionals can gain much insight into how they or their companies should view ethics, and how to most ethically treat their various stakeholders.

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Article Summary: “Securitization of Life Insurance Assets and Liabilities”

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Center, January 2004*

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Securitization involves the repackaging of assets or cash flows into securities that can be traded in capital markets. By creating these new instruments, companies can manage their risks more efficiently. Securitization is also another way for insurance companies to get alternative sources of financing, which might be difficult or expensive to get due to the fact that the insurance industry is heavily regulated. In this paper, the author analyzes securitization in the insurance industry, lessons learned from previous securitizations and new techniques that can be employed to better manage risk and increase return for insurance companies.

The securitization process begins with an originator, which includes bank and thrift institutions that generate mortgages and other type of loans, insurance companies and more. Without securitization, the originator keeps the assets generated with the sale of a product on its balance sheet. Through securitization, the originator can move these assets off of its balance sheet by transferring them to a special purpose vehicle (SPV). The author argues that in the perfect markets model, securitization doesn't create additional value, since it only involves transferring assets to another institution and then reselling them to investors. However, the author points out the fact that the perfect markets model assumes that markets are frictionless and complete, with no transaction costs, no taxes and no regulation, which is not the case for any markets in the world. The author points to several economic reasons for companies to use securitization.

- ◆ The existence of bankruptcy costs:

Through the use of securitization, companies can reduce their leverage, manage risks and enhance overall financial strength.

- ◆ Managing interest rate risk: Interest rate risk is especially important for financial institutions. For example, when originating mortgages, banks can use the securitization process to manage their interest rate risk.
- ◆ The reduction of informational asymmetries: By transferring assets to SPVs, the securitization process lets investors value the assets separately from originators' other operations, which may not be transparent to investors.
- ◆ Agency costs: Agency costs arise whenever the interests of managers and owners of a firm are not aligned. Since assets are transferred to a SPV out of the managers' control through the securitization process, investors' concern over managers pursuing their own interests rather than the firm's is addressed to a certain degree.
- ◆ Regulatory requirements: Through the securitization process, certain assets and liabilities can be moved to SPVs, therefore lessening regulatory requirements for the firms and freeing up capital.
- ◆ Investors' preferences: Since investors have different risk preferences, transferring assets or liabilities to SPVs and grouping them together according to their risk characteristics might make them more attractive to investors.

The author also discusses some of the most significant securitizations in the life insurance industry in recent years by placing them into 5 main categories and discusses 3 of them in the paper.

1. Block of business securitizations: Life insurance companies amortize the expenses associated with writing new life

insurance policies throughout the policy term. However, they generally incur those expenses in the first year of writing the new policy. This may increase the leverage of life insurance companies. Through securitization, life insurance companies can reduce leverage, obtain immediate access to the profits expected from the block of life insurance policies and still meet their regulatory capital requirements.

2. Reserve funding securitizations: Through these transactions, life insurance companies seek relief from reserve requirements, to reduce their cost of capital, and to reduce their leverage in order to be able to finance new businesses.
3. Life insurance risk transfer securitizations: An unexpected increase in mortality rates can create significant risk for life insurance companies. Reduced longevity for annuity and pension products raises the expected value of an insurer's liability to policy holders.. Through securitization, companies can reduce the amount of risks that they are exposed to.

One of the conclusions the author reaches is that securitization can be a very good tool to increase the efficiency of both insurance and financial markets. It also helps to lower the regulation, costs which can make insurance more affordable to customers. The author also points out that despite the associated efficiency gains of securitization, regulatory reasons are a major factor in securitization deals. The author indicates that securitization transactions with the potential to enhance market efficiency should be facilitated through regulation.

Life insurance securitization transactions tend to be quite complex compared to other types of securitization deals. These additional complexities increase the degree of informational asymmetries and therefore reduce credit ratings and increase costs. Taking out particular risks through securitizing can be an effective way to reduce complexities, which

in turn reduces costs and may lead to increased trading activity for these type of securities.

Finally, the author argues that securitizations in the life insurance and annuity industry will not achieve the success of mortgage backed securities and other types of asset backed securities unless they are traded more in public markets. Since most of the transactions to date were initiated as private placements, their potential to increase efficiency and diversification hasn't been fully utilized. The author recommends that for a public market to develop, some degree of standardization and simplification of transactions is required.

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