

The British banking debate after Bob Diamond

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Summary

- Bob Diamond's resignation as Chief Executive of Barclays bank clearly marks a turning point in the politics of banking in the UK.
- The most significant political and regulatory outcome from these events will be to renew the debate about universal banking. Whereas to date this debate has focused on scale, implicit subsidy and systemic risk, it will now focus on culture, personal character and contamination from the values of the trading floor to the rest of a banking institution. Because these things cannot be regulated, the probability is that politicians will focus on their proxies, especially pay.
- The gap between the inherent values and perceived risks of retail and investment banking has been further widened by the events of the last two months. For leaders of universal banks, especially those who have risen through investment banking, closing this gap in the mind of political stakeholders poses a particular challenge. Mr Diamond's belated 'citizenship agenda' at Barclays was well-conceived, but fatally hobbled by this tension.
- By falling on his sword, Mr Diamond has created the possibility of a rapprochement between his former bank and British political opinion formers. The bigger issue for the bank he leaves behind and others like it is how - or if - it is possible after the crisis to rebuild political and regulatory confidence in the kind of financial markets businesses he dedicated his career to building and the people who run and profit from them.

Bob Diamond's resignation as Chief Executive of Barclays bank clearly marks a turning point in the politics of banking in the UK. The announcement that Barclay's was to be fined £290mn as part of a settlement with the FSA financial regulator over its part in the fixing of the London interbank lending rate between 2005 and 2008 proved the tipping point for Mr Diamond. The Barclay's CEO has long been the most controversial of Britain's bank leaders and had few political friends. Yet in the end, the trigger for his resignation was not direct political pressure, but the FSA's intimation to the Barclay's board that unattributed threats from the top of Barclays to the Bank of England had made Barclays' relationship with its regulator potentially toxic.

Mr Diamond's departure and the LIBOR-fixing scandal will mark the start of a new phase in the politics of the banking crisis in Britain. The suggestion that traders at Barclays and other banks were manipulating what is ultimately a key public benchmark for pricing financial products compounds a run of mis-selling and tax planning controversies. With a Parliamentary enquiry now to take place on the LIBOR issue in the UK, and the issue likely to ripple across other jurisdictions and produce both litigation and possible prosecutions, banks in the UK are confronted with new levels of political and public disdain. The fact that the Bank of England's own conduct remains subject to question in some aspects of the LIBOR scandal will not deflect from this.

It is safe to assume that the setting of LIBOR will now be moved into the remit of the UK financial regulator. Brussels will tighten market abuse rules to apply criminal sanctions to tampering with indices like LIBOR. But the most significant political and regulatory outcome from these events will be to renew the debate about universal banking. Where this debate has to this point focused on scale, implicit subsidy and systemic risk, it will now focus on culture, personal character and contamination from the values of the trading floor to the rest of a banking institution. Because these things cannot be regulated, the probability is that politicians will focus on their political proxies, especially pay.

The return of Vickers

The link between what has happened at Barclays and the universal banking argument is trust. Preserving the universal bank model relies on public trust that the core retail functions of a bank and its trading activities can be properly and completely segregated. The UK Independent Commission on Banking chaired by Sir John Vickers proposed in 2011 that they could be preserved in a single institution but in separate entities, with the retail functions ringfenced with their own higher capital levels. The Vickers Commission recommended that all derivatives services should be kept outside this ringfence.

The UK government accepted the argument that retail banks should be able to maintain some simple derivatives functions such as products for hedging currency risk for business clients. The Barclays experience is already leading politicians and commentators in the UK to argue that simple derivatives may be an oxymoron. Trying to define them may be a futile exercise, and one that will inevitably be gamed by banks.

The UK government shows some reluctance to revisit its interpretation of the Vickers proposals. But if the British Parliamentary enquiry into the LIBOR issue now concludes that the government has erred on the side of trusting banks, then the pressure for an outcome closer to the original Vickers recommendation, to be written into next year's Banking Act, will be intense.

The universal banking debate will take another serious twist if the new leadership of Barclays ultimately decides to break the bank up into a retail bank and an investment bank and broker/dealer. As extreme as this sounds, the intangible costs in political and regulatory animus Barclays now attracts could suggest that a clean break makes sense. An arrangement that gave existing shareholders a stake in both new institutions might be acceptable.

Barclays would no doubt sell such a split as a smart commercial move. But the political and regulatory subtext would be to undermine the case that such banking agglomerations are both necessary and useful. Although the French and German commitment to their own universal banking systems is very strong, such a split would certainly empower critics of the universal banking model in the EU and the US. The Liikanen Group inquiry is due to report to the European Commission on bank structure later this year. The Commission itself is then expected to issue its own recommendations on bank structure. Both will certainly draw on the Barclays experience.

The culture question

This bigger issue about the values of the trading floor is going to prove hard to shake off. The role of securities divisions in driving investment bank profits over the last two decades has predictably seen a generation of securities managers rise to the leadership of investment and universal banks. While it is perhaps unwise to generalise too much, most of these men have brought with them the directness and self-belief that comes with surviving a career on the trading floor.

They also bring with them a view of the market and of market-making that is often at odds with the way most politicians understand them. Watching Lloyd Blankfein of Goldman Sachs trying to explain to the US Senate in 2010 why it was legitimate for Goldman Sachs as a market maker to be both long and short in the US property market at the same time reinforced the point. There is a yawning gulf between a trader's pragmatic view of financial markets and a wider political and public audience who generally

interpret the market maker's pragmatism as cynicism, detachment and short termism, especially when it results in making a lot of money.

Banks tend to be highly impatient with this public and political ambivalence. Most banks' response to efforts at greater regulation of securities markets have often been rooted in the argument that these markets are fundamentally a forum for free trade between consenting adults and should be treated as such. It is this argument that the LIBOR-scandal, with its taint of market fixing, and the persistent flow of suggestions of contempt for customers and clients, does so much to undermine.

The events of the last two months have succeeded in cementing for good the idea that the banking crisis of 2008 was ultimately the result of unethical, 'casino' behaviour on the trading floor. Whatever failings banks might have exhibited in their ethical standards here, the reality is that the banking crisis had its roots in poor lending and risk standards, and poor management of loan book funding, rather than wild gambles or duplicity in the securities markets. The Vickers Commission explicitly recognised this by focusing on raising capital standards at the retail banks that make up the backbone of the British credit system.

Recent huge losses in the Chief Investment Office at J P Morgan and conduct like that of Barclays' traders have made this distinction far too subtle to insist upon politically. This may not matter much in regulatory terms - regulators have already embarked on a wide range of securities markets reforms. But it will help embed the persistent political idea that retail banking is inherently 'safe' while investment banking and securities markets business is inherently 'risky'. To which recent events have added the taint of suspect ethical conduct.

For universal bank leaders who have come out of the securities world, this is likely to be part of the challenge of dealing with politicians and regulators over the next few years. Politicians actively questioned Mr Diamond's credentials to lead a retail bank when he was appointed Barclays CEO in 2011. His departure leaves an even greater

burden on universal bank leaders to understand the growing political gap between the skillset desired of retail bank management and the caricature of the men and women who make a living on the trading desks. Mr Diamond maintained a glass office on the trading floor at Barcap even after his transition to leadership of Barclays; a gesture heavy with meaning for his critics.

Mr Diamond's instincts were to close this gap by championing a 'citizenship' agenda for Barclays. The main problem with this is not the agenda, or the work that was done by the bank in its name. It was the persistent undermining of this message by the perceived conduct of the bank itself. Not just questions of culture and character raised by the admission that traders had sought to manipulate LIBOR rates for personal and institutional profit and the mis-selling of payments insurance and interest rate hedges for small businesses. But also fundamental questions over the bank's business model, the way it rewards its highest earners including Mr Diamond himself, its approach to its own tax affairs and the 'aggressiveness' of the tax services it provides to clients, irrespective of their legality. In this, obviously Barclays is far from alone.

Politicians are at something of a loss as to how concretely to address these issues of values and character and this poses a particular challenge for banks. Culture is hard to regulate and the public have no real appetite or patience for reassurances that a renewed rigour from supervisors will fix the problem. The proxies for culture are going to be pay and senior accountability, and these are the two things that ultimately tripped up Mr Diamond at Barclays. Although many in banking would like to argue that these things are beside the point, politically they are the point.

Like much else in the current banking model, the case for remuneration levels in banking is based purely on the logic and discipline of the free market for financial services. Yet the bailouts of 2008 and the LIBOR-fixing scandal have further exhausted political and regulatory patience with the idea that banking exists in a free market. High levels of remuneration are also glaringly at odds

with the wider economic context and the prevailing political climate. George Osborne, the British Chancellor, has tried to accommodate London-based investment banks by resisting the rather rigid rules inserted at the last minute by the European Parliament into the European CRD4 Directive applying ratios for fixed and bonus pay at European banks. But in doing so he is well aware that he is badly out of step with the public mood.

The accountability problem is as simple and blunt as politics gets. The massive market disruptions of 2008 and the ensuing economic crisis have created a latent political desire for personal accountability from the banking industry that it has so far been unable to meet. In part this is because the most egregiously managed institutions in the period leading up to 2008 have simply disappeared. The survivors are generally not inclined to feel implicated in the industry's wider collective problems. Mr Diamond always seemed to hint at the indignation of an executive whose bank had survived the banking crisis without direct government support and who felt he had little to answer for, at least until his employees' malpractice made this untenable. This is part of what made him such a lightning rod and figure of resentment for many politicians.

The political fallout

How will this play out politically? The UK's Labour opposition has clearly judged that there is mileage in a renewed campaign against the bankers. However, although Labour supports a tightening of the government's proposed rules on derivatives inside the ringfence for British retail banks proposed for 2013, its ultimate aim is not a particular regulatory outcome but something closer to a moral posture on capitalism. Labour leader Ed Miliband has broadly disowned the banking record of the Labour government before 2010 and has put a "better, improved capitalism" at the heart of his election platform. This is achieving some resonance in the media. His aim is to use a moral and ethical critique of banking as a way of differentiating himself and the Labour party both from its own past and the Conservative-led Coalition government. The Coalition

government inevitably will be forced to cover the same ground.

The Conservative party is much less inclined to make a moral issue of banking, still less of capitalism more widely. However, most of the very small number of genuinely forensic critics of the banking sector in the UK Parliament are Tories, and often individuals with financial services backgrounds. The Chancellor George Osborne currently seems more inclined to use the LIBOR issue as an opportunity to attack Labour's record in government, but if other banks are fined and the Parliamentary enquiry is highly critical, then he will have to tuck to stay close enough to the public mood. His own backbenchers have already started to grumble that he has misjudged the LIBOR scandal by playing it for politics rather than a question of principle and policy.

For an industry that is used to justifying its social role largely in terms of taxes paid and jobs created, this is difficult territory. Assuming that banks accept that there is a need seriously to tackle and talk about internal culture, providing evidence of this response is not easy. It will require bank leaders who are more visible, vocal and accountable, and internal management that is willing to pit the long term interests of institutions against the short-term culture of the trading floor.

For boards, and in particular the many non-executive board members of banks charged with providing external oversight of institutional conduct and compensation, this adds both additional responsibility and additional exposure. It will require a keen political ear. But it will also require politicians and regulators to engage in a more subtle debate about culture. And care by politicians that their desire to curb unacceptable behaviour does not spill over into a threat to the existence and competitiveness of the banking sector as a whole.

By falling on his sword Mr Diamond has created the possibility of a rapprochement between his bank and British political opinion formers. The bigger issue for the bank he leaves behind and others like it is how - or if - it is possible to rebuild political and regulatory confidence in the kind of financial markets businesses he dedicated his career to

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