

# CSFI

CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

5 DERBY STREET  
LONDON W1J 7AB

TEL: 020 7493 0173  
FAX: 020 7493 0190

**Blue-skying the banks...financial services after the sub-prime/ Northern Rock debacle. A (sort of) round-table with Phil Middleton (Ernst & Young), John Tattersall (PwC), Andrew Freeman (McKinsey), Chris Gentle (Deloitte), James Sproule (Accenture), Richard McManus (PA), and Simon Walker (KPMG) held on Tuesday, May 20, 2008, at the City Club, 19 Old Broad Street, London, EC2N 1DS, From 6:30-8:15pm.**

To achieve blue-sky thinking from the UK's top consultants required blue-sky thinking from the CSFI and the result was a roundtable within a roundtable. Seven experts sat around a table with informed hecklers in a ring around them. The first speaker drew the short straw and started the ball rolling. Firstly there was no catch-all solution for all parts of the financial markets. Second banks must retreat from the "gleeful expansion", high leverage and excessive lending of recent years. Instead three themes would emerge. Dull old retail banking would regain popularity as banks valued their depositors; as banks retreat from riskier activities, new players such as SWFs will come in; and consumers will demand an end to laissez-faire regulation.

Already there was disagreement. The second speaker said higher spreads would ensure bank profitability and he saw no end to securitisation despite the current hoo-hah – it would emerge in another form. The third speaker agreed, saying banks would remain the same but definitions – such as transaction vs. trades – would change. The fourth speaker warned of a major shift away from the US and Europe towards the BRICs and OPEC economies. No, the fifth speaker said: he could not envisage new entrants building up the merchant bank it took the West decades to create – look at Japan. Quite frankly, the sixth speaker said, the current participants were not fit for service. The incentive system was skewed and banks too large to manage. To close the circle, the seventh speaker said emerging market (EM) banks would take advantage of the situation and buy into Western banks.

Having staked out their ground, the speakers debated several key themes: the role of the BRICS, the outlook for regulation; the incentive system; the role of risk management and the likely shape of investment banking. Regulators would insist on higher capital requirements in exchange for state safety nets, many agreed. However one speaker warned against a repeat of Sarbox while the second speaker said greed would return eventually. One member from the outer circle said there had to be internal change as the system was broken. Another agreed saying the "market-centric" model has failed and a new model must replace it. The sixth speaker agreed "steady as she goes" was not an option while the third speaker insisted the underlying model was here to stay.

Some speakers said banking could become a utility function with appropriate rates of return. However the fifth speaker said JP Morgan would look like a "genius" within three years when the deals it was doing now bore fruit. Credit risk would come back in time. If JP

Morgan was a winner, who were the others, the chair asked. Goldman Sachs, the second speaker said. The issue was how quickly banks could learn the lessons. The sixth speaker insisted banks were serial offenders and existing boards were not capable to oversee reform. The incentive system had paid people to be asleep at the wheel. Boards had done great damage to their brands and banking overall.

There would be change, the second speaker insisted, as unless they changed they would not access new capital and customers. In three years' time, risk management will be fit for purpose. One outer member warned the lesson from LCTM was that banks were reluctant to change while regulators simply laid the path to the next crisis. In particular the Fed had "looked down the barrel of a gun" twice and given in. Maybe, the third speaker, said, but regulators and voters had had enough. Bank crises and an OECD recession would strengthen the hand of the "something must be done" crowd. The fourth speaker said governments might be hindered by the fact financial services provided so much tax revenues. Others speaker warned investment banking was mobile and able to flee restrictive jurisdictions. Those not tainted by the sins of the past will be the winners. But what about the sinners, the chair asked. One member said capital requirements would be the umbrella solution and that would push returns lower. Risk management would be a key element – should be part of their DNA - yet some banks will struggle to go back to basics. The sixth speaker said banks had shown "heroic" innovation in balance sheet engineering yet precious little for consumers. The third speaker disagreed, highlighting fixed rate mortgages as an example.

One member, a risk expert, was exasperated by a lack of blue-sky thinking from the roundtable. He said their mindset was simply "unsteady as she goes". He suggested two major changes: from SWFs who have \$1bn of new money a month to place; and emerging market investors. Another, a lawyer, saw two scenarios. The first was a return to narrow banking under pressure from consumers. The second was that non-execs in these nascent utility banks would insist the sexy bits of the business were sold. Another, a regulator, said regulators were always out of synch as they could only do what a consensus opinion wanted and had to stick with that until it turned out to be invalid.

Incentives were a sensitive issue. Many speakers said they did not want regulators involved. However even as the roundtable was running, Hector Sants of the FSA was telling a bankers' dinner regulators would take remuneration into account when assessing exposure to financial risk. The second speaker said it was a competitive market and banks had to pay the market rate. The issue was not the quantum but how they were structured. So where will the City be in five years? Life would be different thanks to consolidation, the seventh speaker said. Margins would be high; banks conservative and regulation grind on slowly. There will be significantly fewer mid-sized players and those doing riskier business will be hedge funds and SWFs. The sixth speaker insisted the current model was fundamentally flawed. New talent would not longer find the rewards in banking and innovation would move elsewhere. Any remaining innovation must be directed towards customer satisfaction and the cost structure.

The fifth speaker said investors not regulators would lead the market, greed would reappear by 2010. In the meantime investment banks dependent on high value trades would face problems. He agreed the people offering risk and reward would be SWFs and EMs. The fourth speaker said it was the end of the "nice" decade for banks, which must

focus on cutting costs to raise margins. London may not be the financial centre as the gravity moves East. He feared the next crisis could be a blow-up in commodities. The third speaker said the current mood would last 18 months but that trust would return. The shift to the BRICs is exciting but presents its own risks. He worried about systemic risks such as a Chinese downturn or a regime change for the dollar. The second speaker said banks would survive but ownership would change. Niche players would emerge and the big banks would learn from them. The last words went to the first speaker. Just as the Internet failed to destroy retail banking, so investment banking would survive. However he saw three trends: a shift towards economic growth and corporate ownership by the BRICs; recycling of petrodollars; and innovation to meet the challenge of aging populations. There would be a regulatory backlash with tighter regulation of banks seen as dependent on the taxpayer.