"INVESTMENT BANKING: THE CULTURE OF A CASINO OR OF A PROFESSION? "

Lecture by

MR PHILIP AUGAR

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Chaired by: LORD SHARKEY

THE CHAIRMAN:
Ladies and gentlemen, it is 8.56 and I think we may as well start before there are any weather interruptions. Thank you very much for coming this morning for such an early start. It is my great pleasure on behalf of New City Agenda to introduce today's speaker, Philip Augar, who will be well-known to all of you I think. In brief preparation for introducing Philip, I looked at Wikipedia of course (so I did some detailed research!) and also to cross-check I looked at Philip's own website, and what I can say about both of these sites are that they are very long. Philip's track record, his achievements and his accomplishments are far too long to go into at this time in the morning, but I would point out two things. First of all, Philip has been commenting on banking issues and other issues since 2000. He is the author of several very famous books and commentaries and he is an active participant in the game rather than simply a commentator. Philip has just pointed out to me in conversation that his experience even extends to being a non-executive director in government departments, something that I plan to take up with him afterwards. I have always wanted to know what exactly it is that these people do! Philip has asked me also to say that he speaks to us here this morning entirely in a personal capacity. With that, Philip, could I invite you to speak?

MR PHILIP AUGAR:
Thank you very much for those words of introduction, John. It is good to know who this week's visitor to my website was - it was you!

Good morning and thank you very much for coming along on a truly horrible day. The title of this talk "Investment banking: the culture of a casino or of a profession?" suggests, rightly, that there are two competing views of investment banking. On the one hand, we have the LIBOR-rigging, bank-busting, client-cheating foreign exchange-rigging world of the newspaper headlines. On the other hand, we have the world described by the Chief Executive of Goldman Sachs, Lloyd Blankfein, who described it as follows, and I will read a quote, speaking of his company's work:

"We help companies to grow by helping them to raise capital. Companies that grow create wealth. This, in turn, allows people to have jobs that create more growth and more wealth. We have a social purpose."

So there we have the two views: on the one hand, the view of the Wolf of Wall Street, the Jordan Belfort view, the Gordon Gekko view, the culture of the casino; on the other hand we have, according to Goldman Sachs, serious financial institutions carrying out an important social purpose in a responsible way. Who are we to believe? And this morning's talk really is going to examine both of those views and try to reach a conclusion.

I thought we might start though just with a definition of who we are talking about when we discuss these investment banks and what we mean by them. Investment banks are the financial institutions which offer advice, financing and trading to the world's corporations, financial institutions and investors. In addition to those things, to a greater or lesser degree, they invest their own money for their own profit. The industry is dominated by a handful of firms. It tends to be the same handful of firms over the years. Most of them are US-based firms. A couple of them are European - Deutsche Bank are based in London for its investment banking operations, Barclays is a leading global player - and there are some fringe players on the edges, but we are really talking about these big, global financial institutions.

It is an incredibly important industry for the UK and for the world. It is important for the UK because over there are hundreds of thousands of jobs spawned by investment banking, large amounts of foreign currency earned by investment banking and enormous amounts of wealth that ripple out over the whole of the South East. That is one reason that they are important. The other reason that they are important is because their organisations are incredibly influential. They are brilliantly connected. Their tentacles reach out into the most senior levels of the country's board rooms. I am talking here about investment banking, but they also reach into parts of banking, commercial banking and High Street retail banking. In very subtle ways their culture affects these other activities. Also, and it is appropriate for me to mention this in this place, they are incredibly well connected in government. Their tentacles reach all over Westminster and over there into Whitehall. These are really, really important institutions. They are so important. As Lloyd Blankfein's definition says, their social purpose is potentially so important that it is essential that they strike the right tone and that they model the right kind of behaviour for the rest of society to follow. So who are we to believe, Jordan Belfort or Lloyd Blankfein?

Let's start with some very easy stuff. There is no doubt that investment banks do perform some useful services. The question is whether they do so in a socially useful way and whether those socially important functions are so mixed up with the whole business of money-making that the whole thing is a hopeless mismatch that gives a bad message to society and which helps breed unfairness and inequality.

Still on the easy stuff, the question is not whether investment bankers per se are bad men and women. I have no doubt that most investment bankers are very decent people in their personal lives. They give generously to charity; they help old ladies across the road, I am sure; and they do not bust into the queue at Waitrose on a Saturday morning. In their personal lives they are decent people and in their professional lives they are extremely hard-working. I was in the industry for a number of years; I still do some projects for it. The hours that they work are extraordinary. The commitment that they have to their activity is in many respects admirable. These are deeply committed people. I also think that the number of investment bankers who actually break the letter of the law as opposed to the spirit of the law is relatively small. This is not an industry where there are hundreds of thousands of them out there breaking the law every day. The number of criminals in the business is indeed relatively small.

Still on the easy stuff, nor do I believe that chief executives deliberately ran their businesses onto the rocks in 2007 and 2008 because they thought that the state would bail them out. This was not deliberate.

But the bankers' favourite defence, which is that just a few bad apples have given the whole barrel a bad name, does not stand up to real scrutiny, and that is what I want to demonstrate in the next few minutes. I believe that investment banking was until very recently, and in fact may still be, institutionally flawed and to some degree morally corrupt. Morally corrupt; not financially corrupt.

The problem starts with the traditional integrated model that investment banks practised which was riddled with conflicts of interest. The traditional model of investment banking allowed banks to act for buyers, for sellers, and to invest their own money simultaneously. Under that scenario how can you possibly put the client first? Which client do you put first? Do you put the buyer first? Do you put the seller first or do you put your own firm first? It was an impossible thing to juggle and it led to, I am going to argue, the practice of putting self before client far too often

Another problem with the integrated structure is that by having so many activities together and close by in single institutions there were far too many opportunities for information to leak from one department

to another. That starts to explain why share prices tend to move in advance of big deals taking place. The integrated structure also gave the investment banks an extraordinary informational advantage over other market participants. In a previous book I called this “the edge”. These institutions just know what is going on. In the course of a day, the amount of information that flows across dealing rooms tells them what leading investors are thinking, gives them an insight into edge of curve patterns of behaviour in commodity markets, energy markets, bond prices, actually even on the high street. Through their connections with company boards and corporate chief executives, they know exactly what is happening in the high street. They know what the top people are thinking. They are able (or they were until very recently) to link that together to produce market-beating returns and, in turn, that generated the massive rewards in the industry that, in turn, spawned the bad behaviour that we know about. It started with that integrated business model.

Thus from the big rewards comes the defining culture really of the industry, which is greed. “Greed is good; greed is great” in the words of Michael Douglas in a famous movie. The rewards in investment banking as practised until very recently were so high that it was possible to make life-changing sums in a single year. I worked in the industry through until the late 1990s and even then people’s understanding of a 4x4 was not the kind of motor vehicle that you see driven round the streets sometimes rather aggressively; the industry’s understanding of a 4x4 in those days was that you were given a deal that was worth $4 million a year guaranteed for four years. Not common but it certainly existed. Life-changing sums that often could be earned by relatively ordinary people, albeit with certain talents and a certain mindset. No wonder that traders called the annual bonus negotiation their biggest single trade of the year.

It was worse than that because not only could you earn life-changing sums in a single year, but the way that the money was paid out encouraged a take-the-money-and-run kind of structure because it was frequently paid out within weeks of the end of the financial year. This encouraged unscrupulous traders to put on trades that generated a significant profit in year one but which left the bank with the residual risk. Sometimes these trades would have a long payback time, possibly several years, so you earn your bonus, you take the money, you leave and you leave the financial institution with the problem on its balance sheet.

The integrated structure and the rewards on offer and the common practice as it then was of investing with the banks’ own money led to a culture that was disrespectful of the client. It led to the practice of putting oneself, either personally or institutionally, in front of the clients’ interests. You can tell that by the term that investment banks use to classify their clients. It is a rather seedy, grubby phrase to me. I have never used it personally except in talks like this, but I have heard senior figures in the industry whom I really respect come out with this, and they will refer to an individual client by reference to their size of wallet. It is a horrible term: “size of wallet”. It says it all.

Probably the best anecdote I have ever seen about disrespecting the client came in Michael Lewis’ first book *Liar’s Poker*. Michael Lewis had just finished time as a bond salesman with Salomon Bothers and the book - I am sure many of you have read it - is a very amusing and very perceptive account of life on the trading floor at that time. The department that Lewis worked for had a particular piece of, they called it merchandise. It was a line of securities that they wanted to sell and it was clear to many, and to Lewis in particular, that this particular piece of merchandise was over-priced, but nonetheless Lewis did his job and sold it to a client with whom he had built up a relationship. The client buys it; high fives all around the trading room: Lewis is a hero. Shortly afterwards the price of the bond heads south. The client is furious and Lewis feels terrible. He is unwise enough in the culture of the time to reveal his unease about what has happened and he confides in a colleague, who says to him, and I will always remember these few words because they say it all really: “Michael, grow up. Who do you work for, Salomon Brothers or this guy?” It is a disrespectful industry where the culture is not to put the client first and it is not about treating customers fairly.

This is coupled with an extraordinary self-belief that I feel borders on arrogance. There is no way apart from their way. It is not just that they believe their way is usually right but in the eyes of the investment banking community their way is the only way. It is only about free markets. It is only about deregulation. It is only about the ethos of the market-place. Consequently, the industry closed out

competing voices. It closed out those who dared to speak up that there might be something wrong with the model. It led the industry to make breath-taking statements about its own omnipotence. The quotation with which I began this talk from Lloyd Blankfein, the one about performing a social purpose, also laid claim to the extraordinary idea that investment banks - and you might comment on this, Christopher, later on - were merely “doing God’s work”. It led to the Chief Executive of another big bank, when confronted with the activities of the London whale over there which cost his bank billions, to describe this event as a “complete tempest in a teapot”. It led to investment bankers the world over prematurely claiming quite soon after the onset of the crisis that “the time for remorse has passed; let’s move on”.

This self-belief cost the industry dear and it certainly led to arrogance and it was that that spilled over into dangerous business practices.

The first of these business practices was a total belief in the infallibility of the risk algorithm. The investment banks were very quick onto computing and very quick onto technology and they worked out models based on the JP Morgan “value-at-risk” idea that were meant to mean that risk could be controlled perfectly. I have seen an investment banking presentation which claimed not merely that risk could be transferred from one to the other, that was the old way, but the new way was that risk had been transformed.

The self-belief and the over-confidence in the risk algorithm led to banks taking reckless business risks that eventually of course led to state bail-outs. It led to an extraordinary run of success generating massive returns both personally and institutionally, but the people at the top had a lack of interest in management, in governance. It has always been a kind of industry where the real heroes were on the desk writing tickets, winning deals. Managers tended to be dismissed as backroom bods. The real heroes do not do the managing; they are out there doing deals, and when you ally that with this self-belief in the virtue of what they are doing, it led to an incredibly unstable situation.

In due course, of course, the fault lines emerged. The fault line was for a long time the undetected rigging of public markets. It is the rigging of the public markets that has caused me particular concern because the public markets are society’s North Star. We need to know certain things in our financial community. We need to know that there are certain benchmarks on which we can rely. Instead we find that the interest rate benchmark worldwide has been rigged for a long time. We find that the foreign exchange markets, in which there is a market turnover of trillions and trillions of dollars, appear to have been rigged, and one of the core aspects of capital markets, the raising of new money for new companies, the initial public offering market, we discovered in 2003 that that had been rigged too. This is all the pillars of investment banking which we absolutely really require to be robust and straightforward. All three have been shown to be faulty over the years. Then if you just add the lack of transparency and misbehaviour in the derivatives market you find an industry that was really deeply and institutionally flawed. That seems to me to seriously damage the claims that they have been working for the public good in the past.

This complacency really cost the industry dear. I want to go back to the year 2003. The New York State Attorney-General Elliot Spitzer had discovered that the new issue market in the United States whereby companies come to the market, sell themselves to investors and become listed on the exchange, had been rigged for a long time. Banks were selling companies to investors that they knew had doubtful prospects. The hottest of the new issues were being passed on to the bank’s friends. There was a closed insider circle. That was a brilliant piece of work. Elliot Spitzer has slightly blotted his copy book since then, but it was a fabulous piece of corporate detective work. It revealed that a really important part of the bank’s model had been flawed, involved deception, involved putting the banks’ interests ahead of the clients and it involved being less than straightforward. The banks in 2003 agreed a settlement of just over $1 billion. A sensible industry at that point, an industry that was not smitten with its own brilliance, that did not have an excessive self-belief, that was not complacent and arrogant, a sensible industry at that time would have thought, “Okay, so we have found this kind of behaviour going on in one of the industry’s core activities. Is it possible that similar kind of behaviour might be going on in other parts of our business? Let’s do a line-by-line analysis. Let’s look at every single business area. Let’s scrutinise it. Let’s subject the practitioners in that area to a real cold, hard look and see what we

discover." They did not do that all. Instead they pressed on, chasing the next bubble (which happened to be mortgage-backed securities) which blew up in '07 and '08 and which led to the revelation that indeed similar deception had been at work, it would appear, in interest rates and in foreign exchange and derivatives markets. It was a very expensive mistake. The Spitzer settlement cost the investment banks just over $1 billion to settle. The current bill for the latest crisis is $100 billion plus and still rising.

I feel that there has been something of a turning point in the industry. I think it took the LIBOR to drive the message home. What I want to try and do in the next five minutes or so is to really try and examine how the industry has changed. It is very, very difficult to know because the practitioners in the industry are persistent at chasing down those who doubt their word. They are incredibly plausible. Many of them are absolutely terrific salesmen and many of them have a genuine belief in what they do, so it is not as if they are lying. How can we get behind what it is these guys and ladies are saying to find out what they are really doing? I think the only way to do that is actually to look at some of drivers of the bad behaviour of the past and see whether those drivers are still there.

The first driver that I identified was greed and the greed was driven by the high rewards that were available to practitioners in the industry. It is fair to say that now the industry is less profitable and consequently pay is lower. I do not think that 4x4s are available any more in the industry. I did some research last week to find this out, not by offering myself on the market you understand, but by talking to some people who run these institutions. Industry is less profitable; pay is lower. Also, the way that pay is given and bonuses are paid are much better. Many banks have introduced a provision for clawback which is if you are given a bonus and it later on emerges that the deal which generated the bonus turns sour, if it turns out that you have been misbehaving, if it turns out that the bank itself gets into trouble, provision has been made to reclaim the clawback. It is called "malus" and in the event of malus the bank can claw back the bonus.

Also the widespread practice that existed in the 1990s and early 2000s where much of the bonus was paid out in year one within weeks of the end of the year has been replaced and now bonuses are deferred over several years. That stops this practice to a large degree of taking the money and running. So in one important driver there has been a clear change.

I think it is also fair to say that the experience of the past has finally got rammed home and the greater deterrents that are now in place are beginning to have an effect. You would have to be crazy if you were a trader over there in Canary Wharf or across the water in Wall Street to be having careless conversations on email or on recorded messages after what has happened. You have seen colleagues arrested. You have seen some charged with criminal offences. You would be crazy not to take notice of that. Similarly, I think management has now much more got the message that you have to supervise thoroughly. You have to do that line-by-line analysis that should have occurred in 2003.

These places are really extraordinary. There are trading floors the size of - and I have worked on some myself - two or three football fields. They are miserable places to be. There is no natural daylight. Often because of the technology that causes the floor level to rise there is not really much room overhead. You put 1,000 people on there, highly motivated, incentivised to make money, organised into little knots; you just cannot assume that all of them are behaving well, so you have to have this detailed supervision, this relentless focus that I think is now beginning to take place, and it is helped by the fact that compliance which until relatively recently was considered to be a rather irksome backroom function is now seen as an important business tool. I think the deterrents have had an effect.

Most importantly, I think that the business model has been cleaned up as a result of certain structural reforms. In the US, investment banks are now banned from engaging in proprietary trading in most parts of their business so the previous practice of betting the bank's own money alongside a client trade is much more difficult. People who work at the big banks tell me that it is impossible to do, others say there might be ways around it and the industry is still discussing this with the regulators, but it is a significant change. Large parts of the investment banking business that caused such problems previously have been driven out. They have gone to private equity firms. They have gone to hedge funds. They have gone to separate organisations altogether. It is a big change.

Still on the theme of structural reform, the derivatives market in which so much of the malpractice occurred and which really took place off the market over the counter has been brought now back into the public arena. A search light has been shone on it and it is much more transparent than it was.

The third development that I think has improved the industry that has weakened one of the drivers of bad behaviour is much more trading now takes place electronically with the click of a mouse, the press of a button rather than the voice broking, the personal contact that made it so easy and so tempting to operate by a nudge and a wink. So I think there are reasons to believe that things may have changed.

However, there are also reasons to be cautious and I am certainly not calling victory yet, by any means. First of all, I think it is important to recognise that investment banking is actually not like other professions. You have to think why you go into investment banking. In most professions you go the profession for a number of reasons. Obviously you want financial security. You probably like the status but you are probably interested in the product. Let's say you wanted to become an architect. Why would you become an architect? Why would you submit yourself to six years of training? Because you want a secure future. It is quite an important job. People generally think well of architects. You are a respected figure in the community, but you would also go into it because you have got a flair for it. You are maybe good with drawings. You have an eye for detail. You are interested in how buildings look. That is how many professions operate. However, you have to think what is the product of investment banking? The product is money. And I think there is something different about a business where the product is money. I think that it attracts a different kind of person and I think that it breeds a different kind of behaviour. That presents the industry with a real challenge if it is going to change the culture. It has to recognise that it is dealing with a different kind practitioner, a different kind of professional to, say, the architect or the lawyer. It is not insurmountable but I think it is a really very high barrier.

So let's look at what is actually happening? Certainly the tone from the top has improved. Consistently the Wall Street banks and their counterparts in Europe are giving a really different message. You will have seen the report probably in last week's *Financial Times* about a video from the head of Deutsche Bank in which he addressed employees very firmly, looked them firmly in the eye and lectured them about the need for good behaviour and culture carriers in the organisation. You will have heard Antony Jenkins at Barclays really making a genuine effort to change the culture of that organisation. However, I am not convinced that the tone not from the top is really deeply rooted. There are reports (anecdotal only) that when Jenkins gave his global call to arms about the need to change the culture, there was sniggering on the floor of the trading department in New York. There are again anecdotal stories than when confronted with the need to clean up their behaviour, some investment banking employees moved from the investment bank to fringe organisations like trading firms or hedge funds. It is not yet deep-rooted. It is not yet completely felt from top to bottom.

I also notice with some concern that the banks are continuing to lobby for a weakening of the rules. They are lobbying hard about the detailed implementation of the Volcker Rule, the rule that bans them from proprietary trading. They are lobbying about the ring-fence that will be introduced in the UK. They are continually trying to change the regulations in their favour. It is because regulatory arbitrage in this industry is absolutely ingrained. For years and years and years they have practised regulatory arbitrage. It is almost like Formula One racing really where each year the authority tightens up the rules and the teams try and find ways round them. You can see a clear example of this, and I do not want to do Michael Lewis' publicity for him here, but his most recent book was called *Flash Boys* and it was about bad behaviour in a new part of the market, electronic trading. No sooner does a new thing come up than practitioners start to find a way around it.

I also feel that conflict of interest still exists in investment banks. I do not work in an investment bank any more. I do not know how much the Volcker Rule, the ban on proprietary trading, is going to stick. I know there are some academics in the audience today and I would encourage them to take a look at this. I think it is a really fruitful area for further research. We really need to understand what is happening in detail. Has proprietary trading really gone away or has it just gone underground?

I also think that the rewards will gradually recover. What is happening at the moment to the industry is

that returns are depressed by new laws which require them to hold more capital against balance sheet distress and runs on liquidity. But this is also occurring during a cyclical downturn that will not last forever. I think in due course, as the global economy recovers, profits will recover to some degree and rewards will recover too.

I am also concerned that in large parts of the industry pricing is still opaque. It is very hard for a customer to know what it is really paying to transact when the bank makes its return by trading.

Finally, I want to just try and weigh up whether we have here the culture of a casino or whether we have a profession. My conclusion is that, despite some encouraging progress in the last couple of years, we do not yet have a profession, because the drivers of bad behaviour still remain, particularly high reward and conflict of interest. I think that to really eliminate the drivers the industry needs to undergo further structural reform. I think that trading needs to be disaggregated from advisory business. That will then enable the industry to genuinely put the client first and then to serve its vital social purpose. We do need investment banks to carry out financing and trading and advice to make the global economy work. The model that I propose would mean that it would then also be able to combine that with achieving the professional status that I think its top practitioners really secretly crave.

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