Makeover required *for* casino banking

Investment banking, argues PROFESSOR TED GARDENER, is suffering from a poor reputation, but it is still a potentially important driver of global economic recovery.

In the aftermath of the financial crisis, investment banking has attracted a great deal of hostility from all quarters. The popular use of the label "casino banking" says it all. The investment banking industry effectively committed reputational suicide by paying big bonuses barely months after the worst financial crisis in modern history. Since then its "street cred" with both public and politicians has plummeted. At the same time, major British investment banks have shrunk as a result of the post-crisis economic scenario, some much publicised scandals and the respective political fallout.

Investment banking and its aggressive, profit-seeking culture were significant factors in the build-up to the crisis. Many also see the propagation and post-crisis continuance of this kind of culture into other areas of banking as a fundamental problem. Recent banking scandals appear to bear out these concerns.

Nevertheless, investment banking cannot take the entire blame for the crisis. The reality is that there were also many other important contributors to the crisis – including lax regulations, rating agencies that got it wrong, poor banking risk management and inappropriate macro-economic policies, to name but a few. At the same time, economists are still trying to understand fully how all of these many contributory forces interacted and fed on each other to produce the so-called "perfect financial storm".

The post-crisis regulatory response to perceived risky banking has been exceptionally severe. In both the US and UK, proposals are well in train to separate investment banking from mainstream retail banking. At the same time, other regulatory controls are also changing the nature and business model of banking.

An inevitable consequence of these new rules is that the business model of banking is being changed in a transformational way. These moves by themselves, though, cannot reform the pre-crisis banking culture that sought ever higher risk-taking and leverage.

These transformational changes are also happening during a period of deep and prolonged recession in the West. Even the so-called BRIC countries are now beginning to experience weakening economies and slower than expected growth. Potential risks (especially with the continuing Eurozone crisis and sovereign risk) remain high. The banking industry in general and investment banking in particular are currently in serious retreat. Several leading banks (including Barclays, Credit Suisse, Goldman Sachs and UBS) have developed redundancy programmes. It is estimated (by the UK Centre for Economics and Business Research) that there will be 100,000 fewer bankers (down to 255,000) in the City of London than five years ago.

Investment banking has been especially hard hit by the present recession and stagnating post-crisis economies. As trading opportunities and fee income have plummeted, investment banking has had to retrench strongly. Many are also concerned that the new and much stricter risk containment rules for banks in general may also constrain bank lending, and this new lending is badly needed (especially by the cash-strapped smaller business sector) to help fire up and sustain the economic recovery

These pressures bring with them a search for new business models in investment banking. Cutting staff costs is only one aspect. Specialist investment banks are giving way to universal banks that combine investment and other kinds of banking, including retail. Diversified banks of this type, for example, attract better credit ratings. Investment banks are also expanding into other areas of banking, like private banking and corporate lending.

Such developments stimulate much speculation about the best kind of business model for investment banking going forward.

Up to 2007, London's impressive rise as a major international financial centre, with capital markets exertise and investment banking centre stage, was seen by many as a considerable threat to US dominance. Industry watchers now ponder whether post-2007 developments and recent scandals may shift the centre of gravity of investment banking away from London and New York (towards Singapore, for example).

Despite such doom and gloom scenarios, some can see a positive message for global economic recovery from all of these recent cost-cutting moves. Investment banks are often said

to cut most strongly just before the economic cycle turns. If this is true (and it is borne out by anecdotal evidence), then cutting staff may be a good countercyclical indicator of the returning health of the economic cycle.

Regulators and the public at large will increasingly demand a more ethical banking culture. These popular expectations and political demands are not going to go away. This applies to banks in general and investment banking (one of the most dynamic parts of modern banking) in particular. Stricter bank regulation is necessary, but it is not the whole solution. Indeed, excessive regulation may even encourage some banks to move into more riskier business as they seek to innovate around the regulations.

Changing banking culture is a major challenge. Two likely development paths are steps to improve corporate governance systems (that recognise the special role and unique market features of banking) and a re-professionalisation of the industry (involving the need for bankers to be professionally qualified and an increase in the role and influence of professional standards boards in the banking industry). These kinds of developments are already under way in the UK. They are needed not only to restore confidence and help sustain the health of the banking system, but also to protect London's global position as the leading international banking centre.

Investment banking is currently under threat as never before during modern times. Given its strategic importance and the high-quality staff that it attracts, investment banking is one of the strong potential drivers of economic recovery. Investment banking has been a crucible of innovation in financial systems – indeed, many would argue that this is a key strategic feature of investment banking. It now needs to harness these considerable strengths and re-engineer itself into a more publicly acceptable and economically sustainable format.

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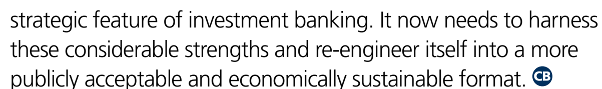

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