Comments on 'Internally-Driven Ethical Reconstruction: Is it Happening?'

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First of all, let me say how I enjoyed reading Robert Annibale's contribution to this discussion. It is clear that Citi is making genuine, credible, and compelling changes in the way they do business, with an eye towards addressing the sorts of issues raised by the *Edelman Trust Barometer*, and many more besides. We've come a long way from Gus Levy's glib jokes about Goldman Sachs' strategy of 'long-term greedy'—a maxim, incidentally, they observed when they were the first to safely exit their subprime positions in 2006, and one they violated when they helped construct the ABACUS trade in the late 2006 and early 2007. Ten years on, no one talks like this any longer, at least not publicly, and instead we see bulge-bracket banks, like Citi, making a concerted effort to change the way they do business.

I think, however, Citi stands apart, for reasons that the speaker's presentation could not address in detail. More so than its peers, with the possible exception of Bank of American Merrill Lynch and Barclays, who are in similar positions, Citi started and remained, even after the acquisition of the rump of Salomon Brothers, via the Travelers Group, a retail bank. In plain terms, Citi's core business has always involved taking consumer deposits, issuing credit cards, writing commercial as well as residential mortgages, offering trade credit to businesses, serving what politicians like to call 'the real economy.' Salomon was once a distinguished merchant bank, and Citi certainly is a serious player globally in the investment banking space, but the ethos of the firm, from what I can see, was always more 'embedded' in the real economy than some of its competitors.

This is a question of 'swings and roundabouts' as they say in Britain, as this has made Citi more vulnerable, for instance, to the vagaries of the US Fed's stress tests, though 2015 was a standout year on that score, and also made the question of nationalisation in the wake of 2007 all the more urgent. They could let Bear Sterns fail; letting Citi fail would have meant something else entirely. Which raises an issue that regulators still have not resolved. Everyone from Barney Frank to John Vickers, and many others besides, would like to see a return to Glass-Steagall era segregation of merchant/investment banking and retail banking. Many of us don't think that's realistic, especially if British and American banks are to remain globally competitive, but politicians, especially those on the Left, with whom I might otherwise be sympathetic, have pushed the issue repeatedly. I think, though, that the experience of Citi suggests this may not be such a good idea, as I think some (but not all) of Citi's commitment to ethical business practices, corporate social responsibility, and inclusive finance, comes through its retail business and the responsibilities thereof. Investment banks may be providing institutional money to crowd-funders and microfinance initiatives, but few of them care as much as Citi does about the state of play on the ground.

By the same token, Citi's commitment to the real economy has also created ambiguities with Basel III and the capital adequacy requirements. These measures are generally agreed to make banking safer, but they also make banking less profitable, and they also make banks less inclined to lend to Main Street, unless, of course, that lending comes in the form of residential mortgages. Sadly, this is one of the reasons that housing bubbles have been the main transmission mechanism, especially in the UK, for quantitative easing. Internal risk management principles, including the requirement that 'decisions are 3) always systemically responsible' are admirable, but decision-making is often constrained by external forces, some of which are inadvertently counterproductive.

The other regulatory issue that the speaker's talk did not address in detail is compensation. I personally have no particular problem with investment banks paying the market rate for those in sales & trading and M&A. But some of those compensation packages are jaw-dropping, not least because base salaries have gone up as bonuses have become suspect politically. That ratio of the difference between an MD in sales & trading and an office boy (or mailroom clerk) is beginning to rival and even surpass those of the Golden Age Robber Barons. The problem, though, is that an individual bank can't address this problem alone, or it will lose its most productive employees to its rivals. I have heard those on the far left argue that it would be fine if the high flyers left, as they take the risk with them, but I don't really believe that. They just get replaced by equally aggressive and often less competent understudies. But to regain community trust, something must be done on this score across the sector, if not to curb salaries, then at least to make a better case to the public. Because realistically, you and I might know that financial institutions, including central banks, either contribute to or fight inequality in a number of different *structural* ways, and that wealth has a lot more to do with inequality than salaries of a minority of employees, but what the person on the street sees is a widening salary gap.

A related issue, I suppose, is the growing awareness of a global super-elite, which is increasingly disconnected from the communities in which its members happen to reside. This is not about the Top 1% or Top 2% by wealth or salary, though most people who fall into it might credibly be classified that way, but rather about large, expatriate communities that appear to locals at least to be clustered in financial services centres—New York, London, Hong Kong, and Shanghai—most notably, though places like Singapore, Frankfurt, Paris, Dubai and possibly Sydney all vie for inclusion in the second rank, are mega-cities that attract people who care very little about the fact that they are living in America, Britain, China, Singapore, Germany, France the Emirates, or Australia, and care very much about the fact that they are living and working with like-minded people in one of the world's great metropolises. Everything from house prices to entertainment to the dining scene resolves around this 'fast set', which might profitably be compared to the 'Les Grands' whom Betty Behrens described in *Ancien Regime* Paris. Many of us here have lived and work on the periphery of that scene (and in my own neighbourhood Dulwich, my neighbour, who works in Procurement at Barclays and is South Asian by way of the Seychelles and his Serbian wife, who is a financial services head-hunter, and my family as well, are looked on with suspicion and hostility by some of our more English neighbours, for example). We have benefitted from these cosmopolitan communities, which richly reward us for our choices in living abroad, but we also should know (or we don't then we're being tone-deaf) how feared and resented the global 'fast set' is. Let alone the fact that the individuals involved (not me or my neighbours, but there is a narcissism of small differences when you are fourth-generation South London and can't get on the housing ladder and the foreigners appear to be living large) often have luxury flats in at least three of these nine centres, as well as holiday homes elsewhere. To be honest, the probably aren't driving up housing prices to any appreciable degree, but they are getting the blame for them.

But then, soft power is like that, and when it involves nation-states, it is much easier to address. It's one thing to tell your soldiers and sailors not to go about Japan in uniform. It's something else to tell your bankers to lose the Patek Philippe watches, the Ferragamo shoes, and the Bulgari scarves on the streets of New York. Any bank that tried that on for size would become a laughing-stock almost immediately. Yet in a global economy, where everyone is a consumer, and almost everyone aspires to consume more or less the same luxury goods, this is what people see when they talk about inequality. Even if all of us present know that government housing and infrastructure policy matters a lot more than well-compensated employees going in for a bit of flash and bling, or MDs at major banks and their hedge fund buddies and their clients buying the odd luxury penthouse in Mayfair. Even 10,000 empty luxury London flats is a drop in the ocean when Britain needs to build 40,000 new affordable homes annually.

As I said, we know the reality is very different from the appearances, and it's that reality that I want to address in turn. I think everything Citi is doing is admirable, but there are two trends that we need to discuss. The first is the rise of shadow banking, and the regulatory climate around it. Much of what happened in the wake of the last financial crisis has forced the riskiest activities out of banks, into hedge funds in the case of sales and trading, and into private equity in the case of mergers & acquisitions. Moreover, big institutional players, pension funds, insurance companies, most notably, have been on the lookout for a bit of gearing, as their actuaries remind them of long-dated liabilities, which cannot be met by instruments that too closely track base rates. As I am discovering in a research project with some colleagues, a frightening proportion of infrastructure project finance in emerging markets these days never hits an investment bank's balance sheet, though there may be some advisory fees involved, at least for firms like Macquarie. The *Bank of International Settlements* cannot meaningfully track most of this activity, there is actually somewhat less financial engineering (as firms like Blackstone are tending to take both the debt and equity, i.e. buying 'the whole project') than in the old days, but there is also far less transparency.

To the extent that some of these entities are genuinely risk-bearing, there may very well not be systemic issues involved, and maybe the BIS isn't the best placed to monitor them. But there are considerable stakeholders issues, and I personally might be a lot happier if they were handled by Citi, then by ABC Capital, who has a mandate from some public sector pension, who under the ERISA rules has to put some of its money in *alts*, and who has already done a deal with Elliot Associates to take on the junior debt the second the government even looks like it might have trouble with a payment.

I am not here to malign 'shadow banking', and I don't even particularly like the term, but I am concerned that the same regulatory processes that have fuelled its growth in the last ten years have also contributed a great deal more opacity than the average person knows. And I also know some of these people personally. The buyside is not known for creating saints, even if the sell-side took most of the rap in the last crisis.

The other trend we need to discuss is the growth of alternative finance. Citi is genuinely committed to Inclusive Finance and has been a leader in that space. But most of the big players are not investment banks, and many of new players have set themselves up as orthogonal to traditional banking. Some of this is simply the libertarian impulse that dominates much of the tech sector. Peter Thiel and his friends will tell that by using *Paypal*, you avoid any chance that the government will 'steal your money' (and the Cypriot haircut must have fuelled those fears), or that bankers will charge you large fees. *Transferwise*, despite banking with Barclays, all but mentions them by name in its advertisements about avoiding price-gouging on retail wire transfers. A lot of the *Bitcoin* boom was also about a fear of fiat currency amongst a certain crowd, which saw cyber-currencies as a better bet in an era of quantitative easing, and these Millenials perhaps have different ideas than most of us do about the social utility of The Silk Road or being able to order cannabis as easily as you might order pizza. But a friend of mine, Bob Wardrop, at Cambridge, who used to run a lot of money, 700 million euros to be precise, for Phil Anschutz, has a Centre for Alternative Finance at Cambridge Judge Business School. Just two weeks ago, he was featured in *Consumer Weekly* in an article that claimed that within ten years, a fifth of all consumers will use technology firms for all of their financial products, and that in five years time, half of consumers will use a fintech company for at least one product, and a third will use it for a least half of them.[1] That's a lot of people, and the survey was done across Europa, Asia Pacific, and North America. In emerging markets, the numbers are likely to be higher.

All of which takes me to a final observation. Robert Annibale said that at Citi, ethics are considered good business. I would argue that with the rise of credible competitors to traditional banking, they may also prove to be a matter of survival. Thank you.

[1] http://www.computerweekly.com/news/4500270845/One-fifth-of-consumers-will-trust-tech-firms-for-all-financial-products-by-2025