

We should remember what made the City great – and return to those values

Comment

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As government officials and regulators in the UK are putting the final touches on some of the most sweeping structural reforms affecting financial services in decades, it is amazing how little is said about the need for governance and cultural change in the City.

Yet, if the goal is to curb excessive risk-taking in the banking system, it should be clear that regulatory reform alone is far from being a

panacea. Experience has repeatedly shown how dangerously creative financial minds can be when it comes to finding regulatory loopholes.

What should be addressed is the root cause of the 2008 crisis: the short-termist, product-centric culture that has come to epitomise the City and Wall Street for the past 20 years. This is the message that we, at the New City Initiative (NCI), have consistently emphasised in our dialogue with Cabinet members and regulators.

Most recently, we have put forward recommendations to the Independent Commission on Banking. We expressed our view

that beyond the capital adequacy and ring-fencing solutions which are being considered, the most effective method of addressing excessive risk-taking in the universal banks – as indeed in all financial institutions – is an improved focus on alignment of interests.

In the case of the universal banks this would include closer alignment between senior management and shareholders to ensure key decision makers behave like responsible owners. It would also include a different approach to bonus calculation to ensure key employees do not take excessive short-term risks with the capital of their

shareholders or clients in order to maximise cash payouts to themselves. Bonus deferral over a meaningful period is certainly a solution, but encouraging bankers to re-invest their bonuses in the very products they sell to their clients should certainly be considered. When it comes to risk management, "eating your own cooking" is certainly a healthy discipline.

We have also proposed the adoption of a standardised, comprehensible risk report by all publicly listed banking firms which would be published in the same way as the audit report.

The twin challenges of the risk

report – which should be prepared by an independent third party – will be completeness and simplicity. It should address all aspects of a bank's risk exposure, including exposure to off-balance sheet liabilities through Special Purpose Vehicles and perhaps include a simple version of the banking stress tests.

This risk report should also be standardised – and so comparable across banks – and readily understandable by senior management, shareholders and depositors alike, in contrast to the current risk reporting based on accounting standards.

However, improving disclosure

is only part of the challenge. We remain concerned about the fact that all too often the non-executive directors of banks have had little or no specialist knowledge of the sector.

Given the complexities of the banking system, we feel greater emphasis must be placed on the fitness of directors for their roles within this highly specialised field. The boards of banks could also be required to appoint independent risk assessment consultants reporting directly to the non-executive directors.

More generally, beyond the practical solutions outlined above, we believe that the City cannot be properly reformed if it

remains as misunderstood as it is today. In the minds of most politicians and the public, the City remains the turf of the "Big Six", the banking giants which made the headlines during the last crisis. They ignore the simple but crucial fact that almost half of the jobs in the City are held in SMEs employing fewer than 250 employees. This is the true "Start-up Britain" in the heart of London.

This entrepreneurial City, the City we represent at NCI, has not only been a considerable source of wealth for the country, it has also been a source of stability for the financial system in general. These firms are typically

not deposit-taking institutions, they do not use their balance sheet for trading purposes and, because they are owner-managed, are naturally more inclined to focus on the long term. More can and should be done to encourage them.

We are convinced that it is this somewhat old-fashioned client-centric approach that was the basis of the City's glory in its heyday that will support the future of London as a global financial centre.

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