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From: Andrew Hilton

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CSFI Advisory Council meeting: November 20, 2002

Among the issues that it was agreed the CSFI should look in more detail at were:

- Sarbanes-Oxley (in particular, what it will do to the value of a US listing, and the European response);
- Basel 2 (is it really too late for change? Should we concentrate on Basel 3? What about Brussels?);
- London's competitiveness vis-à-vis other financial centres;
- implementation and enforcement issues relating to the FSAP (including the role of bodies like CESR, the extent to which the UK is being disadvantaged, and vexed issues like listing rules, quarterly reporting, release of sensitive information etc);
- the DWP's Green Paper on pensions, plus regulatory issues highlighted by the Maersk affair etc.;
- the impact of IAS 39 on issues like the treatment of emerging market assets (there is a real danger of unintended consequences here);
- widening spreads in corporate bond markets;
- what constitutes successful regulation (perhaps a health check for N2+1);
- a saner cost/benefit analysis of the attack on financial crime (related to this was the suggestion that we should also look at the macroeconomic cost of excessive regulation);
- pressures to regulate the raters (studies are underway on this on both sides of the Atlantic);
- the possibility of using the gambling market to supplement insurance; and
- the problems of the insurance markets more generally – mis-pricing, inadequate capital, asbestos etc..

A meeting of the CSFI's Advisory Council was held at the City Club on the evening of November 20, 2002. A list of those attending is given as Appendix I and the agenda is given as Appendix II.

I SARBANES-OXLEY

The first substantive issue that arose was the impact of the Sarbanes-Oxley Act – particular its extraterritorial implications. Plender and Montagnon both suggested it would force companies to figure out much more vigorously what the real value of a US listing is. Plender predicted that many firms, particularly from Japan, would choose to de-list.

Other thoughts on Sarbox:

- Will auditors be willing to sign off on the astounding level of detail that it requires? (Davies)
- Is the US starting to use GAAP (and accounting standards more generally) as a trade weapon? (Haarhoff)
- What chance is there really of accounting standards harmonisation?

Montagnon suggested that two (more or less incompatible) models are developing – IAS vs GAAP, Basel vs OCC, Sarbox vs Europe. How far does Europe have to follow the US? Plender suggested that the US approach may dominate for investment banking, but Europe may have more autonomy in the retail banking area.

What role might there be for the CSFI? Fellgett suggested we should look at Jaap Winter's report. (Winter is Chairman of the EC's high-level group of company law experts, and is currently promoting the report the group issued earlier this year, which touches on these issues.) Equally, we could try to get Sir David Tweedie again, to talk on the accounting side. And/or we could get one or two of the US law firms to try and walk us through the ramifications of Sarbox (which is obviously a gift that will go on giving from their point of view). Norton suggested Cadwalader, Wickersham or Mayer, Brown, both of which are plugging their expertise.

II **BASEL 2**¹

The big issue here is whether there is any mileage left in pointing out Basel 2's shortcomings.

Davies suggested that the die is cast, and that (to its credit) the Committee has finally tried to accommodate models. That said, he remains unenthusiastic, and proposed that we should look at "Basel 3" – i.e. at how Basel 2 will have to be modified almost as soon as it comes out.

Davies's feeling that it is too late for change was not universally accepted. Mainelli, for instance, felt that many Continental European banks are not yet reconciled to it – particularly, he suggested, the Austrians.

Beyond that, Fellgett emphasised the importance of looking at the European process. How will Basel 2 be written into EU legislation, and what will that in turn do to UK legislation? Is there a danger that, as a result of Basel 2/CAD 3 UK financial regulation, will change in nature and become much more rule-driven, with more emphasis on consistency than flexibility? Is there also a danger that Basel 2 will be implemented differently on each side of the Atlantic?

¹ Since the meeting, we have published an interesting paper by Charles Taylor, which resuscitates (and updates) the old idea of "pre-commitment" as an alternative to the heavily prescriptive approach proposed by Basel.

Ridley brought up the problems faced by the securities industry.

All in all, it was felt that we should make an approach to Danièle Nouy to come (for the third time) and explain where the Basel process stands.

III COMPETITIVENESS OF THE CITY

Lascelles began by explaining that, in co-operation with the City Corporation, we hope to build a barometer of City competitiveness, in which we will mix a factual context and subjective perceptions about how the UK stands relative to other financial centres.

While the emphasis will be on how people *feel* about City competitiveness, Griffiths emphasised the importance of the factual context. O'Brien was less insistent: the key is to tease out what is on people's minds. What are the issues as they see them? (He also wondered "What is 'the City'?"; it is obviously not just geography.)

Mainelli volunteered some of the data that Z-Yen has collected on international transaction costs. (He also suggested that not everyone sees the greater transparency of the Anglo-Saxon model as being such an advantage; it may be less of a selling point for London than we think.) Brener wondered whether the study should be expanded to look at what people in other financial centres see as the advantages/disadvantages of London; after all, they have the option of moving here.

Harwerth pointed out that the London Development Agency is already doing some work in this area, looking in particular at the impact of housing costs (which are pricing many back office operations out of London), airport access etc. She expressed concern that, at some stage, the better infrastructure in other centres "will cause the paradigm to shift".

Harwerth's concerns were echoed by Ridley. The key issue is where companies will make their next investment decision. He is concerned that, particularly for back office operations, London is already losing out.

Maybe, said Davies. But London continues to have some real advantages. The accumulation of skill (or clustering) is one. A less obvious one is London's ethnic diversity. If you need a Croatian banker to do a Croatian deal, you can find one.

Finally, it was emphasised that we ought to familiarise ourselves with the work that others are doing in this general area. Haarhoff pointed to work already done on London/Paris and London/Frankfurt comparisons, and said that Wendy Hyde (the BofE's agent for London) has carried out surveys.

IV EU SINGLE MARKET

Fellgett suggested that we now need to move on from the FSAP. What's next? Delivery? Implementation? Enforcement? What does all that mean in practical terms?

Montagnon suggested that we should concentrate on CESR: “that is where the real devil is.” Could we get Fabrice Demarigny (CESR’s Secretary-general) to come and talk?

Brener was not so sure that we should skip lightly over the FSAP. There are, he said, several elements in it that will be difficult for the UK. He pointed to the Consumer Credit Directive (on which we have already held a round-table). In his view, much will depend on how the FSA implements and enforces the Directives. We need to bring in the FSA.

On this question of enforcement, Ridley noted that DG Market will bring out a paper within the next six weeks or so. That may change the term of the debate.

V TAKEOVER DIRECTIVE

This is an issue that Plender had suggested. The Germans subverted the Commission’s initiative last year, but “the show is back on the road”. Is it something we should revisit?

Montagnon suggested that the real concern is whether the playing field is level vis-à-vis the US. If it isn’t, just how uneven is it? And how important is it to level it out? A big issue is obviously shareholder rights – where the split is also within Europe (where multiple voting rights and “golden shares” are more generally acceptable). This raised a question, put by Fellgett, about the extent to which we should be willing to compromise the UK or City approach for a genuinely level playing field – either European or global. Which is the greater gain – the single market or transatlantic harmonisation? Ridley put the same point rather pithily: “How much are we prepared to pay to convert the heathen?”

A similar debate goes on over listing rules, suggested Montagnon. We have something to offer Europe on governance; but we may have to make compromises in some areas to get our way. This prompted Griffiths to raise the vexed question of maximum/minimum harmonisation. Do we accept standards we are not comfortable with for the sake of standardisation?

Plender raised the issue of quarterly reporting. The EU is pushing for it, and may even be ahead of the US. But, on balance, it is probably not desirable.

Yes, said Montagnon; it is not very popular with ABI members. But the real issue is not quarterly reporting; it is the rules on release of price-sensitive information. These are difficult to harmonise. (There is a broader issue of transparency that is worth looking at; Mainelli suggested a debate between someone from, say, E-Crossnet and a “transparency freak from an exchange”.)

Fellgett wondered whether it would be in the buy side's interest to accept quarterly reporting, with less emphasis on ad hoc information release if it is general. Worth debating? It is certainly still a live issue.

VI PENSION FUNDING

Brener began by noting that the Department of Work & Pensions has a Green Paper due before Christmas; we need to be on top of it. But there are lots of other issues in this area as well:

- the regulatory issues highlighted by the Maersk affair (Plender);
- the unrealistically high expectations of the general population (Campbell-Hart);
- the shortcomings of the actuaries (including, but not limited to, realistic discount factors);
- the changing role of housing in the mix of savings assets – an issue on which the BofE has apparently done interesting work (Fellgett; Harwerth); and
- the whole issue of FRS 17/IAS 19.

VII EMERGING MARKETS

The real issue here, suggested Plender, is the fact that bank/portfolio flows have been broadly dead since the Asian crisis – and FDI and bonds haven't made up the difference. Why not?

Davies suggested that the volatility of emerging markets has become an increasing problem for the banks – and IAS 39 may exacerbate that by changing the way banks have to account for emerging market assets. He suggested that banks may have to carry capital for local subsidies in local currency, to match domestic liabilities. That means capital could be wiped out in the next crisis – making emerging markets even less attractive.

Montagnon suggested we might look at the usefulness (or otherwise) of the regional development banks. What purpose do they serve? Would Willem Buiter (EBRD) talk on this?

VIII OTHER SUGGESTIONS

A few of the other suggestions on the agenda caught people's interest:

- Widening spreads in corporate bond markets: Is equity market volatility translating into the bond market via KMV-type models and credit derivatives?

- Regulatory failure (or not): It was suggested that the Centre might want to do a health-check on UK regulation on the anniversary of N2. (Lascelles pointed to the recent BBA study, which concluded that the UK's regulatory structure is good, though style leaves something to be desired.) O'Brien suggested that this could tie-in with from discussion of what we actually want from regulation. What constitutes good performance by a regulator? (On that score, Fellgett pointed out that lack of bank failures could be seen as evidence that banks are holding too much capital, and hence that regulation is failing.)
- Financial crime: Ridley suggested we take a closer look at how domestic and international financial crime is being tackled. Are we going about this the right way, given the sophistication of criminals?²
- Rating agencies: Campbell-Hart noted that an SEC study is currently underway – and Ridley said the Treasury is doing something. This needs to be watched.
- Deflation: Although this evinced only modest interest as an issue in itself, Brener pointed to the macroeconomic impact of FSA regulation. In October 2004, he said, there will be a sharp reduction in retail access to a range of household and motor insurance, as a result of European directives. These directives already affect secured lending, mortgage lending etc. Who is looking at the macroeconomic impact of all this?
- IAS 39: This is a big issue for Davies. When it comes in 2005, compliance will be very difficult. It also represents a marked shift to a rules-based accounting system.
- Insurance/gambling: The extent to which the US \$160 billion (?) gambling market can be used to hedge risk that is currently insured is one that Mainelli has been working on. Worth looking at? Linked to this is the second round of asbestos litigation – a major issue for Ridley. More broadly, there was support for looking at prospects for insurance regulation; there is a consensus that the industry is grossly undercapitalised.

² We have been put in touch with a Canadian academic who (it is said) has done interesting work in putting a real economic price on the war against terrorism/money-laundering etc.

Attendees of CSFI Advisory Council on November 20, 2002.

CSFI

John Plender	Chairman, Advisory Council
Andrew Hilton	Director
David Lascelles	Co-director
Fleur Hansen	Manager

CSFI Members

Alan Brener	Royal Bank of Scotland
Andrew Campbell-Hart	FSA
Richard Clark	PricewaterhouseCoopers
Brandon Davies	Barclays
Robin Fellgett	HM Treasury
Dilwyn Griffiths	FSA
Keith Haarhoff	DTI
Christopher Hanson-Abbott	Brigade Electronics
Noel Harwerth	Citigroup
Jonathan Humphries	Aon
Michael Mainelli	Z/Yen
Jerry Norton	Logica
Stephen Norton	Law Debenture Corporation
Peter Parker	FSA
Ian Perham	City Consultants Limited
John Rushton	PA Consulting

Guests

Jonathan Barber	SERM
Roger Brown	British Bankers Association
Peter Montagnon	ABI
Richard O'Brien	Outsights
Sir Adam Ridley	LIBA

Agenda

1. Report on activities (AH)
2. Sarbanes-Oxley/governance issues
3. Basel 2
4. Competitiveness of the City
5. Completing the single market
6. EU Takeover Directive
7. Pension funding
(Neil Record has expanded on this, suggesting:
 - a debate between “establishment actuaries” and “radical actuaries” (the main difference being discount factors for pension liabilities);
 - a round table with someone from the government actuaries department, primarily on pension liability valuation;
 - quantitative assessment of UK government’s occupational pension liabilities by sector;
 - simplification of the pension process (he offers a paper);
 - the logic of final salary pension schemes;
 - does housing mean there is no pension problem at all? and
 - pricing of annuities.)
8. Emerging markets
9. Other suggestions:
 - Transparency and liquidity in international bond markets (Ian Mackintosh)
 - Is the City losing it to the US? (Francis de Zulueta)
 - Why are the regulators so bad at their job? (Zulueta)
 - Are the raters the new regulators? (Zulueta)
 - Whither the London insurance market? (Zulueta)
 - Are boutiques blooming again? (Zulueta)
 - Deflation update (David Potter)
 - Reputational risk in investment banking (Potter)
 - FSA regulation of mortgage business, secured lending and general insurance (Alan Brener)
 - Proposed EU legislation (Brener)
 - Legislation to enforce director integrity: realistic? (Chris H-A)
 - Impact of euro adoption on eurozone national economies (H-A)
 - Prospects for accounting standards harmonisation (Brandon Davies)
 - Basel 2 and CAD (Davies)
 - IAS (and IAS 39) (Davies)
 - Consumer Finance Directive (Davies)
 - Retreat of genuine venture capital – the shift from equity to debt and near-debt (Craig Pickering)
10. AOB