CSFI

C E N T R E F O R T H E S T U D Y O F F I N A N C I A L I N N O V A T I O N

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To: **Members of the CSFI Advisory Council**
From: **Andrew Hilton**

October 23, 2006

Meeting of the CSFI Advisory Council. October 5, 2006.

A meeting of the Centre's Advisory Council was held on October 5, under the chairmanship of John Plender. A list of those attending is given as Appendix I.

Ideas for follow-up:

- A meeting with Callum McCarthy on the implications of his recent Gleneagles speech.
- Can we set up "rapid-response" round-tables on breaking news (eg Amaranth/Vega)? Would there be demand for this?
- Do hedge "funds of funds" pose a systemic risk? Have they facilitated the disguised "retailization" of the hedge fund sector?
- How has the financial services sector changed since the last major economic downturn? How important is it (in terms of crisis management) that banks and hedge funds are now just as likely to have a financial interest in a firm failing as in bailing it out?
- Is fair value accounting likely to exacerbate a credit crunch (eg in the mortgage market) if the economic cycle turns?
- Is NY *really* losing business as a result of SarbOx? Or are its problems more fundamental? Could it be that it is now too *easy* to raise money in London – rather than too *difficult* to raise it in NY?
- Is it possible to calculate the *real* cost of raising capital in London and NY?
- What about a serious look at abolishing stamp duty? Is it realistic? What is London's future if it stays?
- What impact will Project BOAT have on European markets?
- Is there a broader trend towards delisting from established stock exchanges?
- Is there a danger that anti-gambling legislation could hit derivatives markets (eg weather derivatives)?
- What impact will TARGET 2S have on clearing & settlement?
- Personal insolvency: the UK is loosening the rules just after the US has tightened them. What will be the impact on the banks?

Among the subjects discussed were the following:

1. Callum McCarthy's Gleneagles speech (September 16), in which he inferred that the distribution model for personal savings products in the UK is irretrievably broken. How seriously should this speech be taken? What message is McCarthy sending? Can we get him to come and expand? (Or even to write for *FW?*)

The speech stirred a number of thoughts. Michael McKee, for instance, wondered whether the business model could be tweaked to discourage churn and to reward persistence. Kathleen Tyson-Quah contrasted the retail sector with wholesale markets – which (she said) depend on repeat business, and hence on reputation. The issue, surely, is one of incentives: how to get people to pay an honest fee for honest advice.

2. Hedge funds – particularly following the problems at Amaranth and Vega. I wondered whether we had missed a trick: something I have been keen to develop is a "rapid-response" round-table. In other words, when something complex but important, like Amaranth, breaks, would it be possible to pull together a round-table within a couple of days at which journalists, academics, practitioners and perhaps even regulators might be willing to share their knowledge (on a strictly Chatham House basis)? Amaranth would have been a perfect case in point, though it would have been difficult to get people to speak.

The problems at Vega brought up the issues posed by funds-of-funds – which have been so (inexplicably) popular that they may now constitute 50% of the entire market. As one participant said, "the whole of the City is now invested". Essentially, the hedge fund business is now completely institutionalized; funds are even listed on the stock market, so that pension funds can invest. This means that the debate (which we have already had) on the retailization of the hedge fund business may have already become moot. Pension funds are already stuffing themselves with listed hedge funds – particularly in Continental Europe, via UCITS. This is something that should be looked at. It is no longer just banks that are investing.

That said, Jonathan Howitt emphasised that the winding down of Amaranth has been orderly. The amount of leverage is far less than, say, LTCM, and there has been no liquidity problem. Nevertheless, others questioned the potential conflicts of interest – particularly at JPMorgan, which had a longstanding relationship with Amaranth and ended up buying its positions.

It was pointed out that (in Europe, as in the US) hedge funds have became a deeply political issue: "Pervanche Beres is gung-ho to regulate them" (on the grounds that they pose a systemic risk). There is (as Howitt observed) a myth that funds are not regulated, when the truth is that they are regulated – albeit, through managers prime brokers etc.

3. Impact of recession – a perennial issue, but one that is no less important for that. David Green was concerned about the impact of a recession on the hedge fund industry – and, more generally, on financial intermediation. The growth of hedge funds (80% of which, it was said, are managed out of the UK) is indicative of wider changes in the financial sector. As Brandon Davies observed, banks have lost their appetite for risk –

and, to some extent, have been superseded by hedge funds. We need to look at what a recession might do to the new structure of the financial services industry. McKee agreed; one casualty, he suggested, are the so-called "London rules" for orderly debt restructuring. For the first time, lots of banks may well have a financial interest in a firm going bust.

One particular area of concern was the mortgage market – especially in the US (though that always seems a good predictor of problems in the UK). It was pointed out that 40% of US mortgages have zero equity, and that 40% are not for primary residences. Both the US and UK banking systems are very heavily dependent on mortgage business; what happens if it goes wrong?

(As part of the subsequent discussion of IVAs, see below, it was also suggested that, in the event of a downturn in the market, UK banks will be less willing or able to play the role of "possessors of last resort". Like US banks, they may, well now prefer to foreclose, rather than carry housing assets on their books.)

4. International capital markets – particularly the sense that the US is losing business as a result of SarbOx. Is London *really* winning? How realistic is it to expect a rollback of SarbOx? Plender noted that the PCAOB is now saying that the drift away from US markets started in 1996, ie that it predated SarbOx. On the other hand, Joe Coffey insisted that SarbOx is a major reason for the success of AIM – at least, he added, "that is what US companies say". They say it is just too difficult to raise money in New York.

That prompted Plender to ask whether it is too *easy* to raise money in London. Are there too many Russian mining companies in London? Are our standards now too low? "Is London the new Vancouver?" And will there be a blow-up?

Michael Mainelli pointed out that the real issue is the cost of capital. Which system delivers the lowest cost? He said Z-Yen is doing work for the Corporation on this, and would be happy to share it (perhaps through a regular feature for *FW*).

McKee also pointed out that there are now three separate high-level US groups looking at this problem. One (with which we have already organised a dinner) was set up by the US Chambers of Commerce. The others were set up by Treasury Secretary Paulson himself and by NYC Mayor Bloomberg. New York is clearly looking to fight back.

One area of vulnerability for the City is stamp duty. Gavin Oldham suggested we look at the "leakage" of business away from London as a result of this. In his opinion, it remains a big issue for retail markets – though he conceded that there is a lack of definitive statistics. Alistair Milne agreed, pointing out that, in 1990, the government of the day pledged to remove stamp duty if the City "dematerialized". The problem is that, from a fiscal point of view, stamp duty is a cash cow – producing £3 billion a year at a very low cost of collection. (Actually, maybe not so low since CFDs have mushroomed as a way of avoiding stamp duty.)

John Chown made a plea for a "hard nosed" analysis of the cost and benefits of different markets. In his view, everyone is pushing his or her own market – but no one provides an objective analysis of, say, London against NY. After all, we may be promoting the City on the grounds that it is not subject to SarbOx – but what about MiFID?

That, of course, raised the issue of systematic internalization: what will SI do to conventional markets? Plender noted that JPMorgan has apparently decided against SI status – but others may choose differently. As he observed, there is widespread dissatisfaction across Europe at stock exchange margins. It is possible that the same could happen as happened in the 1970s – when the merchant banks set up ARIEL as a parallel equity market. Could the BOAT initiative evolve in the same way?[1] (Again, Mainelli pointed out, this is something that Z-Yen is working on.) We should certainly put together a round-table on Project BOAT.

Milne also raised the issue of implementation costs for MiFID. Part of the confusion about MiFID may come from the fact that systems costs are likely to be very uneven.

Finally, on the issue of capital-raising, David Lawton pointed out that there is a broader trend towards delisting that needs to be looked at. This is not just an issue of taking companies private; there are also increasing questions being asked whether it is worth listing in more than one venue. Multiple listings are increasingly seen as less valuable.

5. Extraterritorial reach - by which is meant the long arm of US regulations. Obviously, gambling is the big issue here – and whether the restrictions on gambling apply to "gambling-like" products, notably weather derivatives. Kathleen Tyson-Quah reminded the group that derivatives were formally illegal in the US for eight months in 1986-87, which is why the off-exchange derivatives markets came to London. She warned that there is a plausible case to be made that what many reinsurers do routinely could now be viewed as illegal in the US – particularly if they do it on-line.

She also urged another look at the SWIFT debacle. Why isn't this a bigger issue?

6. TARGET 2S – and clearing &settlement more generally.

The ECB's proposal for extending TARGET to securities is currently out for discussion with CSDs, with Daniela Russo coordinating. The implications of this are still being worked out, but it was suggested that extending TARGET could cut across Euroclear's business model. Can we get Daniela to explain what is going on?

7. Personal insolvency and its impact on the UK banks. There was concern (a bit late in the day, I thought) about burgeoning "IVA factories", and the impact that changes in UK bankruptcy law are likely to have on banks and consumer credit companies when the cycle turns. As Brandon Davies pointed out, banks are now subject to fair value accounting, which changes their behaviour when it comes to handling impaired assets.

He emphasised that "accounting affects behaviour". FVA makes it harder to handle crises over a longer period. This affects consumer lending; it also affects mortgages.

8. Other issues – including:

- **Audit quality** – particularly the FRC's forthcoming paper on drivers of audit quality (apparently, still in draft). This is a big but difficult issue.

[1] Project BOAT was launched last month (by nine major banks) to create a pan-European trade and market data dissemination platform, in competition with traditional exchanges. The idea is to challenge the notion that exchanges can charge an oligopoly "rent" for market information.

- **Retrospective tax changes** – Gavin Oldham suggested we look at changes to trust law. Chown offered his partner, John Dewhurst, as a possible speaker. He also suggested we broaden the discussion to what he sees as the deterioration in relations between the tax authorities and (corporate and personal) taxpayers. Is the Customs & Excise culture winning out following the merger with the Inland Revenue?
- **Carbon credits** – has the recent fiasco been sorted out?
- **Christianity in the City** – it remains fascinating (to me, if to no one else) how committed Christians (Stephen Green, Ken Costa, John Studzinski etc) can reconcile their faith with a business based on the remorseless pursuit of Mammon. I intend to find out.

Subsequently, Michael Mainelli sent me an email in which he added a number of his own thoughts, prompted by the discussions at the meeting. Some of these are covered elsewhere (eg. Project BOAT), but others are worth thinking about:

- "Great mistakes" – Mainelli is proposing a round-table on "all the big failures over the years from Barlow Clowes and endowment mortgages up to the present". Perhaps this could be led by Alan Peachey, who has just published an expanded version of his "great banking disasters of our time" book.
- History of financial mathematics – the proposal is a joint Gresham College/CSFI session with Santa Fe's Doyne Farmer.
- Intellectual property and finance – the subject of a lecture he gave on October 18, etc etc.

Appendix 1

Meeting of the CSFI's Advisory Council, to be held on Thursday, October 5, 2006 at Bakers Hall, Harp Lane, London, EC3R 6DP from 6:00-8:15pm, under the chairmanship of John Plender.

Chair	
John Plender	*Financial Times*
CSFI	
Andrew Hilton	Director
Rhiannon Davidge	
Sam Mendelson	Programme Coordinator
Members	
Malcolm Aish	NM Rothschild
Peter Andrews	FSA
Alan Brener	Abbey
John Chown	Chown Dewhurst
Neil Fatharly	KPMG
Jon Hogan	KPMG
Jonathan Howitt	Man Group
René Karsenti	ICMA
David Lawton	FSA
Michael Mainelli	Z/Yen
Nick Munn	DTI
Gavin Oldham	The Share Centre
David Potter	Noble Group/CSFI Governing Council
Vicky Pryce	DTI
Alessandro Roselli	Banca d'Italia
Edward Simpson	Finance & Leasing Association
Clifford Smout	Bank of England
Jeremy Stanyard	PA Consulting
Peter Wilson-Smith	Quiller Consultants/CSFI Governing Council
Guests	
Chris Clegg	ALMA
Joe Coffey	Taylor Wessing
Francesco Burelli	Capco
Brandon Davies	GARP
James Elwes	*Financial World*
Alexander Evans	Foreign & Commonwealth Office
Peter Flynn	LINK Interchange Network
John Godfrey	West LB
David Green	FRC
Jonathan Hayward	Independent Audit
Con Keating	Finance Development Centre
George Littlejohn	Folio
Ruben Lee	Oxford Finance Group
David Marsh	London & Oxford Group
Michael McKee	British Bankers' Association
Alistair Milne	Cass Business School, City University
Tony Scott	Oliver Scott Consulting
Timothy Spangler	Berwin Leighton Paisner
Henry Tricks	*The Economist*