

CSFI

CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

5 DERBY STREET
LONDON W1J 7AB

TEL: 020 7493 0173
FAX: 020 7493 0190

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

March 17, 2006

Meeting of the CSFI Advisory Council. February 1, 2006.

A meeting of the Centre's Advisory Council was held on February 1 at the City Club, under the chairmanship of John Plender. A list of those attending is given as Appendix I.

Ideas for follow-up:

- The (pensions-related) bubble in the gilts market. Are pension fund trustees "hedging an accounting rule" rather than a genuine long-term liability? If so, is FRS 17 to blame?
- Why are accountants, actuaries and investment managers all pulling in different directions on the issue of pensions?
- Regardless of whether the emphasis on bonds is good or bad, is it possible to increase the supply of long-dated securities so as to take some heat out of market?
- Is it really possible to find specific pieces of financial regulation that can be rolled back? Or is regulation really a seamless cloth that cannot be unpicked? (And, linked to this, is there really a secret constituency for regulation among larger institutions?)
- Is the current controversy in the US over Basel (Basel 2 vs. Basel IA) playing into Europe's hands, in that third countries are increasingly adopting the European model (Basel 2 compliance for even the ropiest institutions)?
- What impact will the eruption of China and India on to the global economic scene have in the area of CSR? In order to compete with Chinese and Indian firms, will Western oil producers have to ditch their commendable commitment to stop paying off any government official with his hand out? (Will this be reflected in the debate over the Company Law Reform Bill?)
- Is stock exchange consolidation inevitable in Europe? Or is the conventional idea of a stock exchange redundant in a post-MiFID world, where there is no concentration rule and where systematic internalisers are recognised?

A. PENSIONS

The first issue for consideration was the UK pensions problem. Plender suggested that, as a result of the pensions problem, there is now a bubble in the gilts market – particularly in the long-term index-linked segment of the market, where there is an acute shortage of supply. Why? And what are the implications?

This prompted an intervention by Con Keating – who remains convinced that the pensions problem is being exacerbated by official intervention and by new accounting rules. As he put it, the liabilities of DB pension schemes are in fact not interest rate-sensitive, and trying to match them with long bonds (which is what trustees are trying to do) is really just “trying to hedge an accounting standard”.

There was a good deal of sympathy for this position from the cleverer people present; I, however, remain bewildered. Still, it is something we must look at. Peter Montagnon offered a clue: the key (he said) is how one values pension liabilities. At the moment, bond valuations are used, and that drives trustees to invest in bonds. (This is, I assume, the John Ralfe argument; however, I feel there may be a more important point that I am missing.)

Mark Tennant agreed – but went further. In his opinion, FRS 17 provides a misleading valuation of a pension fund’s liabilities. It is driving such funds out of equities despite the fact that they need the long-term returns that only equities can provide. There is the basis for a massive mis-selling scandal here.

Montagnon agreed. At the moment, the accounting standard is driving behaviour – but it doesn’t really reflect reality. Any chance that we could get David Tweedie to discuss how his analysis is being used?

There was a lot of support for taking a hard look at FRS 17 and pension liabilities. Peter Wilson-Smith characterized many decisions taken by trustees under pressure from FRS 17 as “ludicrous” – but was promptly attacked by Keating. They are not “ludicrous” he insisted – just wrong. Long-dated gilts are a hedge, not of pension liabilities, but of an accountancy standard.

Mark Robson observed that, under different pressures, the accountants, the actuaries and the investment managers are all pulling in different – and incompatible – directions. It is clear to him that one accounting standard cannot fit all – and that FRS 17 is driving pension fund investment into the wrong areas. David Green observed that, under the FRC, actuaries and accountant will finally be brought under one roof.

Brandon Davies agreed: Do we want to hedge an accounting standard or a pension liability? They are very different things.

Peter Norman brought up a related issue – the government’s proposed £1.5 million lifetime cap for pension pots (unless you are lucky enough to be a judge).

When the pot was first introduced, he said, it was calculated to provide a lifetime annuity of £75,000. Now, that has fallen to £53,000. Is it still a realistic limit? And ought we to be looking at other, more imaginative approaches? He suggested “tontine bonds.”

Keating went further. In his opinion, forcing firms to fund their pension obligations with bonds of up to 100% solvency must cost at least 0.5% a year – which is a tremendous destruction of value over time, and a big burden on the corporate sector.

So, asked Plender, what can we suggest to replace the present system? This is an enormous public policy issue.

Should companies actually pay pensions, asked Montagnon? Or should they buy out their pensions obligations? I wondered – prompting Tennant to point out that the cost of this would be utterly prohibitive. That said, the legacy of pension obligations is an enormous long-term problem for UK corporates.

The central issue, said Wilson-Smith, is whether there is a better way to calculate – and invest against – pension fund liabilities. Is liability-driven investment pushing us in the wrong direction?

David Lascelles agreed: the sense of the meeting is that the received wisdom is wrong. He wondered if there is a financial engineering angle to this? Is there a “synthetic way to expand the long end of the market”?

Plender suggested that Goldman is already working along these lines. You don’t have to buy “boring old gilts.” However, Barry Marshall was sceptical: derivatives won’t solve this problem. Tennant agreed: someone has to be on the other side of the deal.

Malcolm Aish summed up the problem: At present, investment strategy by pension funds is driven by the need to discount to bond yields, not to equity returns. The problem is that “30 years is a very long time”. The investment climate will change. How will trustees cope with that?

Talk of selling out of DB schemes, he agreed, is unrealistic. Who would be the buyers? But the nature of the obligations might change. The liabilities themselves might change over time.

John Chown wondered whether there is a case for the government selling life annuities directly to the public – a proposal that got a resounding NO (presumably on the grounds of potential mis-selling liability) from both Montagnon and Keating.

B. REGULATION

Michael McKee wondered whether we should focus on:

- the possibility of deregulation; or
- ways in which future regulation could be limited

The problem is that there is so much in the pipeline already.

David Green conceded the problem – particularly with regard to Brussels. Large parts of Europe have no tradition of proper risk assessment – which means it is hard to make this kind of (somewhat sceptical) mindset routine. Moreover, it is very hard to unpick existing regulations – though there is lots of work going on trying to find ways to roll back European-level regulations.

Plender agreed that it would be very difficult to find specific measures to roll back – But is it worth the effort even so?

Kathleen Tyson-Quah suggested (perhaps seriously) that regulators should be incentivised to find rules to roll back. After all, they know the ropes.

Ed Harley – defending the FSA – pointed out that it does have a programme to roll back regulation, and that there is now a very genuine focus on cost/benefit analysis. The problem is that we are “underwhelmed by the response” from industry. There was some sympathy for his position: the industry could do more to help the FSA.

That said, Robin Saunders suggested that it still isn’t absolutely clear what the FSA’s role really is.

Alan Brener wondered whether large financial groups actually want regulatory roll back. Regulations are, after all, a barrier to entry – and hence to competition. “Regulation is basically anti-competitive.”

Tyson-Quah wondered whether the Centre should look at regulation in a bear market. After all, banks couldn’t cut the cost of regulation. What will happen, particularly to small banks, in a bear market? Particularly with the cost of Basel 2, MiFID, SEPA, etc.

That prompted Angus Hislop to point out that different institutions apply regulations in different ways; some are notorious for gold-plating. Usually, “you can do it cheaper” – and, if you are smaller, that can be very important.

Green suggested that we might want to look at the changes to regulation of the audit profession.

C. QUALIFICATIONS

Plender wondered how (or whether) this issue could be tackled.

Marshall suggested we look at the increasing sway of the US CFA qualification – which has now taken over the UK Society of Investment Professionals.

The real issue, surely, is:

- whether one needs professional qualifications for a City career; and
- if so, which?

Although there was agreement that there is *something* for the CSFI to look at in the this area, the discussion quickly focused on regulation – specifically on the recent row that had broken out when the FSA announced that it was planning to drop the requirement for certain players in the wholesale market to have passed key qualifications. As Harley pointed out, there is a certain inconsistency here: much though the City may protest that it wants to roll back regulations, it is actually quite comfortable with the FSA setting standards.

D. REGULATORY COMPETITION

Davies suggested that something new is happening as a result of US ambivalence over Basel 2. In many emerging markets, the decision to become Basel-compliant is pulling financial regulators away from the US model (GAAP etc) towards Europe. This is particularly true of China. The combination of SarbOx and US ambivalence to Basel 2 means that the European model has a clear run – “London cannot go wrong”.

There is, he said, “a battle going on” – and the US is isolating itself. In his view, big American banks are signing up for Basel 2 whether or not US regulators are demanding it. And the result is that the financial world is splitting – with more and more countries adopting the “European” model.

This sounded plausible (through the US preference for Basel 1A still seems to me like an unexpected attack of commonsense) – and there is a lot to play for. Perhaps we should look at how new financial centres view US and European regulatory norms – Dubai? Mumbai?

Sir David Scholey wondered about the (enormous) costs of embracing IAS and Basel 2. Banks feel they have no choice. But does this give new centres a head start?

Tennant drew a parallel with insurance – and the way that Bermuda emerged as a challenger to Lloyds.

One problem is clearly that technology in the major Western markets is not very good. That, however, is not enough. As Montagnon remembered, in 1990, the technology employed by the Jakarta SE was streets ahead of London – and a fat lot of good it did. The key is not so much technology as, for example, the rule of law.

Of course, Tennant pointed out, India (unlike, say, China) has both technology and the rule of law – and Montagnon conceded that India may be “the one to watch”.

The point was neatly summed up by Chris Clegg: “If you don’t have the technology, you *won’t* succeed; if you do have the technology, you *might* succeed.” In that sense, technology is the key.

Maybe, said Hislop. But, in fact, much of a bank’s back office and compliance can now be routinely outsourced – “not just call centres”. This means that even smaller institutions can benefit from technology, the cost of which might normally be beyond them. Tennant agreed – though, he pointed out, it is not just back office/compliance that can be outsourced; it is research as well.

E. CHINA, INDIA etc

Tyson-Quah brought up the challenge of China – which seems to play by its own rules.

One issue, she suggested, is whether the example of China undermines the argument in favour of free markets. Another, suggested by Montagnon, is the impact that China’s increasingly voracious appetite will have on commodity markets – where the Chinese and Indians are competing to tie up global supplies. A third issue, suggested by Alexander Evans, is whether China’s success “will kill off Corporate Social Responsibility for good” – particularly when Western oil companies find they have to fight off Chinese firms in countries like Angola.

That brought up the issue of the Company Law Reform Bill – which will set rules for UK corporates. Robson suggested that we need a round-table on this. It is a big bill, with many agendas reflected within it.

That prompted a discussion of how (or whether) Western firms who face enormous pressure in third markets, or from emerging market exporters, can be helped. As Davies said, it is important to avoid “GM syndrome”.

Nevertheless, said Scholey, it would be worthwhile to look at what established markets (and, indeed, established players within them) can learn from newcomers. As Marshall observed, there is still no financial institution that that has the same “cost ethos” as Dell or WalMart. There may be a reason for this, but it is not immediately obvious.

Defending the High St. banks, Irene Dörner conceded that it is partly a legacy problem: “you wouldn’t start from here.” But there is more to it. HSBC cannot have a single megastore to save 40m customers. Plus the regulatory burden is so much greater than in the retail area. And security. And audit etc etc.

All true, acknowledged Alan Brener. But the fact is that the banks chose to take on the retailers. Have they succeeded? And what have they learned along the way?

F. STOCK EXCHANGES

Plender began by referring to John Thain’s comments in Davos, predicting exchange consolidation in Europe.

In his opinion, this is primarily interesting as a cost issue. “There are a lot of costs in the plumbing.” It is also one area where competition doesn’t actually seem to be working in that too many players seem to be driving costs up.

That approach did not generate universal agreement. Clegg, for instance, wondered if we really need big exchanges any more, Marshall suggested that, in an era of plug-and-play technology, the clamour to take over exchanges makes little sense. This is now a technology business.

Green agreed – and added that MiFID will further undermine the special position of exchanges. Wilson-Smith also wondered if we actually still need exchanges. What functions do they provide that alternative trading platforms do not? By legitimising internalisation and by getting rid of the concentration rule, MiFID could “change everything”. That said, it was pointed out that much the same was said about exchanges ten years ago.

Peter Norman suggested that much depends on the Commission’s review of clearing and settlement through the SESAME group. Clearly, some officials within DG Markt want a Directive; McCreevy, however, is “temperamentally disinclined” to go that route. By the middle of this year, we should see the way ahead.

Scholey warned that “exchanges come and go”. It is easy to imagine that the LSE could go the way of the Baltic Exchange. “Cyberexchanges” are still in their infancy. Clegg was even more wounding: maybe eBay should buy the LSE.

Marshall made the key point that there is really very little difference between bonds, derivatives or commodities: they can all go down the same pipe. Green agreed, and pointed out that Euronext already offers STP for OTC transactions.

G. AOB

Among other ideas that were suggested, the following are worth noting:

- Personal debt: McKee suggested that changes in UK bankruptcy law may be making the situation worse, not better. Regulation of consumer credit will become a big issue later this year.
- Entrepreneurship: Iona Levine suggested that we need to look at the “cultural underpinnings” of entrepreneurship, and at how ideas actually get funded. (Clegg suggested Howard Flight to speak on this; Wilson-Smith suggested we look at the “Aunt Agatha” gap – £1-2 million.)
- ZOPA: Not for the first time, we were urged (by Martin Hall) to look at the ZOPA model – the problem being that no one from the firm is willing to speak publicly.
- Public sector spending: Evans wondered whether we should look at what a slowdown of public spending would mean for consultants. (I think it is more interesting than that: it is sort of “Roger Bootle-type” issue, in which consultants will be only one of many groups affected.) Green suggested we expand this to cover a general economic slowdown, quoting Herb Stein: “If it is too good to last, it won’t last.”
- Solvency 2: Keating suggested we look at the status of the Directive, due later this year.

Hislop concluded with a warning, which we should bear in mind: too much of our agenda is dominated by regulation. We need a balance: perhaps a focus on banking consolidation in Europe. Clegg agreed – we should re-emphasise innovation.

Other suggestions, submitted by people who were unable to attend the meeting, included:

- The astonishing ease with which companies, even down to triple-B can now get funding – which suggests (*pace* concerns about the “Aunt Agatha” gap) that there may be too much capital chasing too few investment opportunities. “It will end in tears.”
- A post-mortem on what the financial sector actually wanted from the FSAP – and did it get it? (No surprise that this suggestion came from Malcolm Levitt.)
- The responsibilities of consumers in the retail financial market place – in other words, a robust look at TCF.

**Meeting of the CSFI's Advisory Council: To be held on Wednesday,
February 1, 2006 at the City Club (Garden Room), 19 Old Broad Street,
London, EC2N 1DS, from 6-8.15pm.**

CSFI

Andrew Hilton	Director
David Lascelles	Co-director
Rhiannon Davidge	
Sam Mendelson	Programme Coordinator
Eleanor Laws	Funding Coordinator
Katherine Lim	Intern

Chair

John Plender	<i>Financial Times</i>
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John Chown	Chown Dewhurst
Irene Dorner	HSBC/CSFI Governing Council
Paolo Garofalo	Banca d'Italia
Ed Harley	FSA
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Beverley Morgan Plumb	DCE Consulting
Chris Pickles	BT Radianz
Mark Robson	LMH, Oxford/CSFI Governing Council
Robin Saunders	JP Morgan Chase
Sir David Scholey	UBS
Eng Hoon Tan	DCE Consulting
Mark Tennant	JP Morgan Chase
Peter Wilson-Smith	Quiller Consultants/CSFI Governing Council

Guests

Alan Brener	Abbey
John Bullard	Identrus
Francesco Burelli	CapCo
Chris Clegg	ALMA
Brandon Davies	GARP
PJ Di Giammarino	
Alexander Evans	Foreign & Commonwealth Office
Geoffrey Fitchew	ICHEIC
Jane Fuller	Fuller Analysis
David Green	FRC
Thomas Harris	Standard Chartered
Con Keating	Finance Development Centre
Iona Levine	Kilbrandon Consulting
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Michael McKee	British Bankers' Association
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Kathleen Tyson-Quah	Granularity
Jon Watkins	<i>Financial World</i>
Margot Wilson	Sapient