

# CSFI

## CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

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**To: Distribution**  
**From: Andrew Hilton**  
**February 20, 2005**

**CSFI Advisory Council meeting: February 2, 2005**  
**City Club, 6-8:15pm.**

A meeting of the CSFI's Advisory Council was held on the evening of February 2 at the City Club, under the chairmanship of John Plender. A list of those attending is given as Appendix I, and the agenda is Appendix II.

**Ideas for follow up:**

- McCreevey's willingness to roll back EU legislation. How serious is it? Is the Commission really committed to cost/benefit analysis?
- The danger of "regulatory homogeneity" and a single view of risk. Do EU Directives and the FSA encourage it?
- If (hypothetically) the UK were to leave the EU, what would we do differently in the regulatory area?
- Is the boom in private equity a positive development or an example of market failure? Does it undermine the "democratic element of the wealth-generating sector"?
- The UK's tendency to "superequivalence" – a real issue or just scaremongering?
- Is the Ombudsman adding another unnecessary layer of UK regulation?
- Will Brussels shift from DG Market to DG Competition as its preferred tool for opening up financial markets?
- Are Europe and the US headed for deadlock over IAS?
- Can hedge funds stay outside the regulatory net? (And should they?)
- What will the European Parliament's role be under Pervenche Beres (and post-Huhne and Villiers)?
- Who oversees the actuaries?
- Let's revisit the idea of "visualising" risk – of constructing some sort of (simple) standard to convey the riskiness of a financial product, either as an intrinsic quality of that product or *vis-à-vis* a particular buyer.
- The battle for the LSE – what does it mean for European market structures? (What does it mean, in particular, if the winning bidder overpays grossly?)
- Is there any chance that the LSE will end up being regulated from Frankfurt? (And would it matter if it were?)
- New AML guidance notes are due, and need a (sceptical) review. Last year's Police Inspectorate report might be a good starting point.
- On corporate governance, we need to look at trusteeship, at the NAPF review and at the impact of Sarbox.
- There is also the broader issue that, throughout the financial services sector, the fiduciary responsibility of agents to act in the best interests of their principals is breaking down.
- Could the national identity card be a platform for a multifunction alternative to cheques and credit/debit cards?
- What new markets might evolve following the success of carbon trading? House prices?
- What would the implications be for the financial services sector if there were a collapse of the dollar as a reserve currency?

**I. Regulation:** David Lascelles began with a brief summary of his forthcoming *Banana Skins* report. The key theme this year, he said, is the increasing burden of regulation. He cited three concerns:

- a trend towards uniformity – in regulation and in the firms’ own models;
- the escalating cost, particularly of compliance; and
- the role of regulation as a barrier to entry and a block on creativity and innovation.

He also noted growing concern with Brussels.

Andrew Hilton followed this up with a brief description of the high-level Working Group on Effective Regulation that the Centre hopes to set up – in part, as a response to the fear that (almost against its will) the FSA is being pushed in the direction of a zero-failure regime.

The idea for a Working Group was generally endorsed: Sir Martin Jacomb made the point that, if caveat emptor disappears, innovation is also likely to go with it.

On the European dimension, David Green pointed out that Commissioner McCreevy has indicated that he is open to suggestions as to what financial legislation should be repealed. Equally, Paul Mills noted that the Treasury is currently looking at FSMA to see if there are regulatory measures that could be dropped.

The same point was picked up by Christopher Boyce who pointed out:

- that the FSA and Practitioner Panel are about to launch a study on the cost of regulation; and
- that the FSA already has a committee looking at reform of the regulatory Handbook, with a report expected in July.

Notwithstanding this, Martin Owen, latterly of the FSA, agreed that the issue of “regulatory homogenisation” is important. The good thing is that global standards create norms – and aspirations to meet them. The less good thing is that this can move us to a single view of risk, with an absence of healthy competition between regulatory models.

Green suggested an interesting counterfactual: if the UK were to leave the EU, what would we do differently (or not at all) in the area in financial regulation?

Philip Warland picked up on this. When one asks regulated institutions “what they wouldn’t do if the FSA didn’t exist”, the result is usually silence. But they still object to the way the FSA forces them to do it. Maybe what we have, he suggested, are the right regulations but the wrong regulatory style.

John Plender agreed that the EU’s output in the regulatory area is now overwhelming. He wondered whether this is just a “hump” (and that the amount of legislation coming out of Brussels will fall) or whether the dynamic is such that the flow of legislation can never be switched off – whatever McCreevy might say. Is the Commission committed to genuine cost/benefit analysis?

According to Green, a test will come in the clearing & settlement area. McCreevy has indicated that he will not propose legislation unless there is clear evidence that it is necessary (Teresa Villiers has already indicated that, in her view, it is not).

Paul Richards insisted that the Commission's emphasis must change. In future, he said, there must be clear evidence that we *need* a directive before one is proposed.

Turning back to the UK, John Chown suggested that we should look at the (largely unregulated) private equity market. At present, he said, venture capital firms employ one-sixth of this country's entire workforce. If they have accumulated this kind of power, isn't it a major market failure?

Plender agreed that there is an issue. Inexpensive equity is in short supply, and expensive private equity is frequently all that is available. Jacomb suggested that another reason for the inroads that private equity is making is that it is getting harder to find people who are willing to be chairmen of public companies.

Maybe, said Peter Wilson-Smith. But private ownership is simply better for some companies. Whatever, as David Wheeldon pointed out) it undermines "the democratic element of the wealth-generating sector." It is a different kind of capitalism.

Peter Montagnon was a bit sceptical. Clearly, the dot.com bubble meant that many companies listed who shouldn't have done so. Equally, the current very low level of interest rates underpins the private equity boom. Nevertheless, he conceded, there may be something structural underneath it all – and, if so, that is potentially serious since private equity is inherently short-term.

Angela Knight picked up on an earlier point. Will regulation keep coming out of Brussels, or is this just a "hump"?

No contest: regulation will keep coming – not least because "careers are not made out of sorting out glitches". The "next good idea" will always happen – and she expressed some scepticism about the quality of the EU's embedded cost/benefit analysis. As for domestic regulation, she was particularly concerned about:

- the UK's tendency towards "superequivalence"; and
- the role of the Ombudsman – since his office can (and does) impose different compliance requirements to those of the FSA.

The issue of the Ombudsman is important. As Knight pointed out, the UK Ombudsman's office employs one thousand people; its analogue in Spain employs just 15. We need to look at it.

Mark Robson made the point that UK regulatory "superequivalence" is not just a financial issue; it also applies to employment law, health & safety, data protection etc. What, he wondered, does this do to London? Will it eventually drive business offshore? "Why do businesses stay in EC3?"

**II. Brussels:** Montagnon wondered if there is a shift underway in Brussels from DG Market to DG Competition. Is competition better than regulation at opening u markets? Certainly, Alex Schaub's last job was in competition (and the Competition directorate has now set up a financial services unit).

What are McCreevy's priorities?

So far, he seems to have *said* the right things – in particular, that he understands the internal dynamic towards new legislation even if it is not necessary. At the same time, as Montagnon pointed out, he is locked into Bolkestein's agenda, which still has to be fully implemented. It will be hard for him to make his mark – though using competition law to sort out clearing & settlement is a possibility.

There was some concern over McCreevy's plans for accountancy. As Green pointed out, McCreevy is a former accountant. Plender (another former accountant) noted that he has already suggested that IAS are too American-dominated, even though the initiative is notionally global (and, as Green observed, China is currently trying to implement IAS).

Another area that McCreevy has indicated he will look at is asset management. Warland wondered if that would eventually mean a directive. If so, the danger is that it will grow like the ISD. A Forum Group (in which London-based firms participated) on this has (rather perversely) recommended legislation, which tends to undermine those who believe legislation should be a last resort.

Two related issues are:

- how to fix the UCITS directive – which is increasingly incompatible with current market practice; and
- whether to bring hedge funds into Brussels's regulatory net.

Gordon Midgley pointed out, on the latter point, that it is very difficult for many Continental European funds to invest in unregulated entities. Hence the push to regulate hedge funds so that they can become an authorised asset class.

A final point on Brussels concerned the role of the Parliament. Montagnon noted that the new chairman of EMAC (or ECON as it is now apparently known) is Pervenche Beres – a French Socialist, who seems to be suggesting that the Committee should have oversight of Lamfalussy process legislation right down to Level 3. Is that correct? And, if so, what would it do to the implementation of financial legislation? After all, as Wheeldon pointed out, the general election seems certain to mean that we will lose two voices of sanity – Teresa Villiers and Chris Huhne – from the Parliament. Tricky times ahead.

**III. Pensions:** John Godfrey began by summarising the paper that he has written using material collected by the Centre in the course of a couple of dozen round-tables we have held on the pensions issue. The key points are:

- simplification
- depoliticisation (perhaps through creation of a new body analogous to the MPC);
- development of new long-term fixed income products geared to the pensions market;
- increased flexibility in the annuity market;
- abolition of means-tested benefits; and
- an increase in the basic state pension.

A thorny issue is tax. Hilton explained that he would have liked Godfrey's paper to have come down firmly in favour of abolishing *all* tax incentives on *all* forms of savings (since there is evidence that tax breaks do nothing to increase the total pot of savings, and that

the only ones who shuffle savings around to exploit them are higher income groups about when we don't have to worry anyway). Jacomb agreed that the paper must at least reflect the debate on tax.

Robson urged the Centre to press ahead with the discussion on the actuarial profession that has been scheduled for a while. Perhaps this can be tied to publication of the next volume of the Morris report.

There was a sense that actuaries live in their own world, with very little accountability outside their own profession. And yet they have a huge impact on asset allocation – potentially in a perverse or procyclical way. Two suggestions for round-tables:

- the Actuarial Standards Board; and/or
- the Financial Reporting Council, which has a monitoring role in this area.

On the issue of long-term assets for pensions funds to invest in, Mills made the interesting point (not followed up) that government is not a natural hedge for longevity risk – which some proposals (for longevity bonds) seem to assume.

On the issue of depoliticisation, Midgley seemed extremely sceptical. As he put it, “politics is about the distribution of income”, and politicians will not want to give that up. (Indeed, David Willetts made much of this point at a CSFI round-table.)

That prompted a brief discussion of financial awareness.

As Chris Clegg pointed out, the problem with *caveat emptor* in the savings area is that we don't have informed *emptors*. This is a huge issue in the pensions area, but how do we address it? Hilton explained briefly the CSFI dinner meeting at the Pru on “visualising risk”; perhaps this is something we should revisit.

**IV. Market Structure**: It was pretty much unanimous that we should do something around the DB/Euronext bids for the LSE – but what?

The key issue for Plender is that there are two bidders – each of whom seems willing to overpay grossly. Who is going to bail them out? (And what form will that bail out take?)

For Paul Myners, two issues are uppermost:

- Whatever the price paid (but especially if the winner overpays), there is going to be rationalisation. What will this mean in terms of trading platforms and clearing & settlement?
- There are also regulatory issues. What would it mean if the LSE ended up being regulated by Frankfurt?

On the latter point, the consensus was that the regulator could probably only move if the LSE became a branch of the DB. That was not seen as likely – though, if the DB chose to go that route, it was also pointed out that the FSA would not be able to stop it. It is certainly an issue that is worth looking at.

More broadly, what does the takeover of the LSE say about the future of London's financial markets? Plender agreed that, to date, the press has largely overlooked the public interest side of the bids, which he clearly thought is a legitimate issue. He also felt

that governance issues are relevant. The DB is only able to overpay so grossly because Werner Seifert is far less accountable in Frankfurt than his counterpart here would be. Lascelles added that Seifert may also be acting under some political pressure – which can lead to irrational decisions.

While most agreed with Myners and Plender, there were dissenters. Robson, for instance, compared the bidding to the 3G licence auction: we survived that – as we survived Continental takeover of most of our utility firms. Why is this different?

On balance, one would have to say there was considerable scepticism around the table on the potential synergies that are said to be driving the merger. It was also noted (by Midgley) that regulators tend to like consolidation: it is easier to deal with oligopolies than with a fragmented market. One strong suggestion: Get Benn Steil, currently at the CFR in New York, to come over and give us his view – either at a round-table or (perhaps) as part of a larger-scale debate.

**V. eFinance:** Two points:

- John Bullard emphasised the increasing importance of OpRisk – of which identity theft is a significant part.
- Hilton suggested that it is probably time for another *tour d'horizon* of the European e-finance scene.
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**VI. AML/terrorist finance:** There was a widespread feeling:

- that, as currently administered, the AML regime in the UK is an illegitimate privatisation of the policing function;
- that it impose an unreasonable cost;
- that reform should be high on McCreevy's agenda; and
- that the absence of feedback from NCIS (soon to be absorbed into yet another acronym, SOCA) breeds cynicism.

Jacomb added that, if the EU authorities were really serious about tackling money laundering, they would simply take the €500 note out of circulation.

That said, Owen pointed out that new AML guidance notes should be out next month in draft. We should try to review these; it may also be worth looking at last year's report by the Police Inspectorate (which apparently concluded that existing AML legislation is pretty ineffective).

**VI. Corporate governance:** As Plender noted, this is an area of almost constant change. The debate has moved beyond the Board to governance of an institution as a whole. He suggested we look at:

- updated proposals from Paul Myners;
- the issue of trusteeship (also picked up Wilson-Smith); and
- the NAPF's review.

Montagnon urged another look at Sarbox: is it a windfall for the UK? Will companies de-list in New York? Or will the SEC's pragmatism stop them moving?

He also suggested an intriguing divergence of approach that appears to be opening up between the EU and US:

- in the US (he said), there are prescriptive rules and (relatively) weak shareholder rights; while
- in the EU, the trend seems to be towards principles-based regulation and stronger shareholder rights.

It would certainly be worth looking at how the EU handles Sarbox while maintaining the principle of subsidiarity. It would also be worth looking at US efforts to roll back Sarbox (which, in Warland's view, is on the agenda for this year).

**VIII. Fraud and identity theft:** Bullard suggested that we look at the implications of the government's proposals for a national identity card. The fascinating point is the absence of any legacy. If the card were to incorporate an EMV chip and a digital certificate, it could become an extremely powerful multifunction alternative to cheques, credit/debit cards etc. He suggested an approach to Ian Watmore.

**IX. New markets:** Jonathan Barber insisted that carbon trading is about to take off. He noted the success of the Carbon Trust on AIM, and felt that pressure from Kyoto will be a driver.

Mills suggested the need for a market in house prices. IG Index has apparently developed regional indices. Wheeldon urged another look at the REITS market – otherwise the UK will lose out to Frankfurt.

**X. Hedge funds:** The primary issue here is the case for regulation. However, Plender suggested we should all look at efforts to measure performance; can we improve the quality of statistics? (Robson recommended a typically impenetrable paper by Con Keating and Bill Shadwick on this.)

**XI. AOB:** Shaun Curtis proposed two Corporation papers as the basis for round-tables (which we are happy to arrange):

- a study (by Alistair Milne) on the impact of recent and prospective EU directives on the corporate bond market; and
- a study on US-imported restrictions on the distribution of trading screens.

Tyson-Quah urged us (as she has before) to look at the collapse of the dollar as a reserve currency – which she sees as inevitable (given that indebtedness per capita in the US is now about US\$380,000). Get Robert Pringle from *Central banking?*

This is probably also the place to note a point raised earlier by Myners.

He was concerned more generally about the failure of the agency function in the financial services area: agents' performance on behalf of their principals seems less and less satisfactory. This is particularly true in insurance (the brokerage problem) and in investment management. There seem to be inherent conflicts of interest that undermine

fiduciary responsibilities – and it seems more and more difficult to incentivise agents to ask in the best interests of their clients.

Other suggestions that we have received, but that were not discussed at the Advisory Council meeting, are listed in Appendix III.

**AH/RD/SB**

**Meeting of the CSFI's Advisory Council: To be held on February 2, 2005  
at the City Club (Garden Room), 19 Old Broad Street,  
London, EC2N 1DS from 6:00-8:15pm.**

**CSFI**

Andrew Hilton	Director
David Lascelles	Co-director
Rhiannon Davidge	
Simon Basey	Administrator

**Chair**

John Plender	Financial Times/CSFI Governing Council
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**Members**

Malcolm Aish	NM Rothschild & Sons
Christopher Boyce	FSA
John Chown	Chown Dewhurst
Chris Clegg	Abbey
Shaun Curtis	Corporation of London
Sir David Davies	EFG Private Bank/CSFI Governing Council
Neil Fatharly	KPMG
Guy Hewitt	Standard & Poor's
Angela Knight	APCIMS/CSFI Governing Council
Paul Mills	HM Treasury
Paul Richards	Bank of England
Mark Robson	LMH, Oxford/CSFI Governing Council
Philip Warland	PricewaterhouseCoopers
David Wheeldon	London Stock Exchange

**Guests**

Jonathan Barber	SERM Rating Agency
John Barrass	CFA Institute
John Bullard	Identrus
John Godfrey	West LB Panmure
David Green	
Sir Martin Jacomb	
Gordon Midgley	Investment Management Association
Peter Montagnon	ABI
Paul Myners	
Martin Owen	
Adam Phillips	Financial Services Consumer Panel
Kathleen Tyson-Quah	Granularity
Peter Wilson-Smith	Quiller Consultants

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**Agenda**

1. Regulation (CSFI Working Group on effective regulation).
2. Brussels – new Commission, new Parliament, new committee structure.
3. Pensions (John Godfrey paper – what thereafter?)
4. Market structure – LSE/Deutsche Bourse/Euronext & clearing and settlement.
5. eFinance – where does it stand & new non-traditional banks (VW Bank).
6. AML/terrorist finance etc.
7. Corporate governance, transparency etc – Sarbanes-Oxley, IAS etc.
8. Fraud/identity theft.
9. New markets – carbon trading etc etc.
10. Investment strategy (hedge funds etc).

**Other suggestions for CSFI work**

Kathleen Tyson-Quah (email January 25, 2005)

1. Decline of dollar as reserve asset (see main text)
2. Extractive industries transparency initiative (DfID): This was launched in 2002, with support from Soros, BP etc. It requires full transparency about all payments and revenues from oil, gas and mining sector projects.
3. The BofE's new market intelligence team (to be headed by Paul Tucker): How is this going?

Howard Davies (RBOS) (email January 25, 2005)

1. The forthcoming Commission Green Paper on retail banking.
2. Forthcoming Communication on mortgages, in response to 48 recommendations.
3. The Commission's thinking on payments.

Malcolm Harper (email January 24, 2005)

1. Regulation of microfinance.
2. What ICICI, ABN/Amro, Citi etc are doing in the microfinance area.

Kathryn Vagneur (email January 25, 2005)

1. "Structural problems" within the corporate governance system – "chain of command" problem. Information is mediated through a command, which implies a clear conflict of interest.

Paul Mills (HMT) (email January 27, 2005)

1. Hedging house prices (see main text)
2. Hedging longevity risk.

Martin Thomas (email January 24, 2005)

1. A Commission view of the changes to market structure implied by the LSE/DB/Euronext bids.