

CSFI

CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

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

July 20, 2005

Meeting of the CSFI Advisory Council. June 28, 2005.¹

A meeting of the Centre's Advisory Council was held at the City Club on the evening of June 28, under the chairmanship of John Plender. The list of attendees is given as Appendix I, and the agenda is given as Appendix II.

Potential CSFI issues:

- Bringing competition into regulation: Is it possible? What about the "26th regime" proposal? Targets for failure? Can regulation be privatised?
- Should the FSA have an obligation to promote UK plc?
- Will MiFID mean the end of the world? Is it really as expensive as Basel 2 or Y2K?
- International audit standards: Is this the next great banana skin in the audit/accounting area?
- SEPA: What is it? What will it mean?
- The sticky fingers of different D-Gs: Aside from Markt, who else has an interest in financial services?
- Green paper on asset management.
- Taking McCreevy seriously on rollback: Can we come up with actual examples of Directives to be repealed or cut back?
- Basel 2: What does the delay in US implementation mean? Is Basel 2 good or bad for developing countries?
- The "visualisation" of risk: Is it worth giving it another try?
- Comparative cost structure of financial products: Can one compare the cost of savings products in (say) 1968 and 2005?
- Is Sandler doomed?
- The implications of hedge funds and private equity: What impact on the quoted market?
- Paypal: Could it conquer the planet with its business model?
- The problems facing pension fund trustees.
- Can one get more competition into global audit?
- The impact of the OFR on the City.

¹ I apologise for being so late with the minutes; in all honesty, I forgot.

Hilton began by apologising for the slightly negative tone of the agenda. As Angus Hislop had pointed out in an email we need to concentrate more on the “I” in CSFI – a valid criticism (particularly since the first agenda item was regulation!).

I OVER-REGULATION

This year’s BBS survey had shown “overregulation” to be a dominant issue, and others (e.g. the CPS) have come to the same conclusion. Hilton briefly explained the status of the proposed Working Group on lighter/smarter regulation, and our hopes for it.

He also explained his own concerns:

- Is it possible/desirable to bring competition into regulation? and
- Can one envisage “smarter” regulation (to get around the problem that complex financial institutions will always require complex regulations/regulators?)

One example of “smart” regulation (he suggested) might be the so-called 26th regime – which he (mistakenly, perhaps) interpreted to mean that there might be a parallel pan-EU regulator that institutions could, at their volition, opt to be regulated by. The existence of that option might (he suggested) provide a check on national regulatory excess.

Even if (as David Green pointed out) that idea is based on a misunderstanding of what the 26th regime is all about, it is worth following up – as are other ideas in the same general area:

- Should regulators actually have a target for failures? (Green suggested this in jest, but it is not a bad idea.)
- Is it possible to “privatise” regulation? – as (Mark Robson suggested) is already done with great success in the building industry. (After all, auditors already take on responsibility for SarbOx in the US.)
- Should the FSA be forced to take on promotion of the City as one of its statutory objectives, so that it would have to respond more vigorously to complaints about over-regulation? (Brandon Davies)

II EU

Turning to the issue of Brussels, Hilton emphasised the importance of putting something together on MiFID – which Mark Tennant suggested (and no one disagreed) is more complicated/expensive than Y2K. Jerry Norton seconded this; we are better prepared than the rest of Europe, but the cost is massive and there is a strong likelihood of unintended consequences.²

Plender introduced the issue of International Audit Standards – which, he feared, would reflect US standards far more than UK or European standards.

These follow on from International Accounting Standards, but they will be difficult to implement given what we called “eccentricities” of national treatment, Green noted that the Directive on auditing had not been agreed, nor is there a date. Nevertheless, this is again something that we should work on.

Another EU initiative that it was suggested we look at is SEPA – the Single European Payments Area. Norton pointed out that this is very important and affects every bank – but

² Shaun Curtis suggested “*The Business*” had done an interesting survey on the cost of MiFID.

very little about it is yet in the public domain. As Tim Jones noted, it may be a way to “unstick” Europe when it comes to introducing fairly standard products (eg direct debit) on a cross-border basis.

Hilton suggested that we ought to try to put a meeting together to explore how often Directorates-general (SanCo, Competition, Justice etc) are muscling in on the financial services space that used to be the responsibility of DG Markt. A lot of other people want to get their fingers into the financial pie.

It was noted that a Green Paper on Asset Management was due to be published on July 14.³

John Ingamells suggested this should be “fairly non-divisive”, and that it would not propose major new UCITS legislation. Nevertheless, as Tennant observed, the Commission’s track record means this should be watched carefully.

Finally, on Brussels, it was noted that, so far, Charlie McCreevy has said all the right things about pausing and about rolling back legislation in some areas.

Is this realistic? Is it possible to fund Directives or parts of Directives that actually could be rolled back? Or is this just an empty promise? This would either be worth a round-table or (even better) a survey.

III BASEL

Hilton said he remains convinced that the US decision to suspend implementation of Basel 2 (ie not to proceed to the next stage, which would be to issue a NPR), while the QIS4 mess is being sorted out, is very important. But getting anyone interested in explaining it (even from our friends at the OCC) is hard going.

The general feeling over here is that Europe will plough on even if the US stops – though Paul Mills did recognise that there are some pressures for simultaneous implementation.

Davies (who used to be sensibly sceptical on Basel) insisted that the US would actually lose out if it did not implement Basel, because the rest of the world is looking to implement Basel 2. Considering where most of their banks stand in terms of risk management, he suggested, even less than 100% success in transposing Basel 2 would be a huge step forward?

An unrealistically huge step? Asked Plender (reasonably). Perhaps these banks should be aspiring to Basel 1 instead.

The discussion on Basel was a bit inchoate, but it would seem that there are at least two meetings that we should set up asap:

- on US implementation of Basel (what does the delay really mean?); and
- on developing country responses to Basel (is it a step too far? are there cheaper solutions?).

³ Green Paper on the enhancement of the EU frame-work for investment funds (SEC (2005) 947)

IV RETAIL FINANCE

Hilton summarised the basic problem as being to produce a good low-cost savings product in a low-inflation world – very difficult given:

- the high cost of regulation/compliance;
- different perceptions of what level of risk is appropriate; and
- the rock-solid belief of everyone in the financial services sector that he/she should earn enough money for the house in Gloucestershire and two kids at Eton.

That prompted a discussion of risk, and of its understanding by the general public. As we have discussed before, is it possible to “label” financial products with a simple, understandable measure of risk? Or is “risk” too much dependant on:

- who is buying the product? and
- what is already in his/her trolley (everything from housing to expectations of inheritance)?

Chris Clegg insisted that this remain very important and must be followed up.

Tennant then introduced an idea that had great resonance.

When he joined the fund management industry in the 1960s (which was a time of generally low inflation), it was possible to offer much cheaper products than now – despite the fact that there were fewer funds and much less competition. Yes, he said, there were significant upfront charges, but the annual management fee was trivial. Why was this?

- was it because the cost of regulation was much lower?
- was it because the remuneration of managers was much lower?
- was it because IFAs didn't have to be sweetened?

Whatever, he suggested, it *ought* to be possible to take a range of fairly simple products offered in (say) 1968 and compare their cost structure with broadly similar products today. The comparison might be very instructive.

Plender and Peter Wilson-Smith both felt this idea would be a natural for the personal financial pages.

Linked to this, the question arose: “Is Sandler doomed?” Although Plender suggested that imperfections in the market mean we may resort to Sandler's approach, there is little doubt that the industry feels that it has put the Sandler threat to bed. That prompted Plender to make a modest suggestion: put MP's pensions on a DC basis, and watch them come alive to the seriousness of the situation.

V HEDGE FUNDS/PRIVATE EQUITY

The issue of commissions/fees in the retail sector is put into perspective when one realises that, according to Andreas Zombanakis, last year managers took US\$45 billion out of the hedge funds and the prime brokerages.

The real issue is whether the Centre has anything at all to add in this area. Possible angles might include:

- The implications for the quoted markets if more and more firms of private. (Plender)

- Are private owners better than institutional investors – and, if so, on what measures? What is the success rate of private equity? (Wilson-Smith)
- Why is it so difficult for quoted companies to give equity back to their shareholders? (Davies)

VI TECHNOLOGY AND E-FINANCE

Jones suggested that one area of interest might be the national ID card. In his opinion, all the information that the government could legitimately need is already stored – somewhere. The thinking behind creating yet another new database is so “old-fashioned”.

John Bullard suggested that we got in some banks to talk about the identity issue (Rick Smith at JP Morgan, perhaps).

The big issue, however, was Paypal, which Jones described as the “real novelty of the internet age”. It now has 72 million customers, it is global and it can deal with any size of payment. It also collapses payment and settlement, and potentially can outflank the banks. It is also just at the point where “network externalities” make it effectively untouchable.

We must pull together a round-table on Paypal in the autumn.

VII. AOB

A Pensions: Graham Cox explained his proposal for encouraging corporates to close pension holes, and indicated that he was prepared to lead a subgroup on this.

Wilson-Smith suggested we look again at the role of pension fund trustees, who face massive obligations post-Myners. Plender wondered whether it might be possible to get Martin Taylor to talk. In his view, the role of the independent trustee is becoming impossible. Also try to get David Norgrove, the new(ish) chairman of the Pensions Regulator.

B Global audit: How do we get more competition into global audit? asked Mills. This is an issue that we need to revisit. There must be a real risk that one of the Big 4 is knocked out, added Plender. How does one overcome barriers to entry?

C The OFR: Jonathan Barber reminded the Group that we must have a look at this.

D Other suggestions: Prior to the meeting, several of those who were invited (but were unable to attend) sent in suggestions. At the risk of mangling their ideas, the following seem worth following up:

- The impact of European Court judgements on current tax structures around Europe – a major issue for investors. (Sheenagh Gordon-Hart)
- What the future holds for trading floors. (Michael Feeny)
- Zopa.com – “a virtual credit union”. (Angus Hislop)
- The “idiocy” of the Insurance Mediation Directive, which the UK is implementing (via the FSA) with a good deal more vigour than, say, Germany. Hence (for instance) the decision by BMW and VW to withdraw extended warranties from the UK market. (Rod Armitage)

AH/SB/RD

Meeting of the CSFI's Advisory Council: To be held on Tuesday, June 28, 2005, at the City Club (Garden Room), 19 Old Broad Street, London, EC2N 1DS, from 6-8.15pm.

CSFI

Andrew Hilton	Director
Rhiannon Davidge	
Simon Basey	Programme Director
Eleanor Laws	Funding Coordinator

Chair

John Plender	<i>Financial Times/CSFI</i> Governing Council
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Members

Chris Clegg	Abbey
Shaun Curtis	Corporation of London
Kees Diepstraten	Abbey
Vernon Everitt	FSA
Dimitris Fatouros	Deloitte
David Green	Euronext/FRC
John Ingamells	Fidelity Investments
Paul Mills	HM Treasury
Jerry Norton	LogicaCMG
Joanna Perkins	FMLC, Bank of England
Paul Richards	Bank of England
Mark Robson	Lady Margaret Hall, Oxford/CSFI Governing Council
Mark Tennant	JP Morgan
David Wheeldon	London Stock Exchange

Guests

Jonathan Barber	Glenfern
John Bullard	Identrus
Graham Cox	
Brandon Davies	GARP
Tim Jones	Simpay
Adam Phillips	Financial Services Consumer Panel
Antonia Sharpe	Betfair
Peter Wilson-Smith	Quiller Consultants
Gordon Woo	Risk Management Solutions
Andreas Zombanakis	European Credit Products

Did not attend

Malcolm Aish	NM Rothschild & Sons
Jim Gillan	Fidelity Investments
Sheenagh Gordon-Hart	JP Morgan
Jon Hogan	KPMG
Alwine Jones	HBOS
Erick Lamothe	Lloyd's of London
David Llewellyn	Loughborough University
Leon MacPherson	Accenture
Michael McKee	British Banker's Association
Beverley Morgan Plumb	DCE City Consultants
Mike Parker	Deutsche Bank
Michele Pison	LogicaCMG
Jane Ridley	
Timothy Spangler	Berwin Leighton Paisner
John Stuttard	PricewaterhouseCoopers

Agenda

- The relentless rise in the regulatory and compliance burden (or, if you are a regulator, the unjustified whinging of the regulated community in the face of what is still by far the preferred regulatory regime in Europe);
- The pipeline of measures coming out of Brussels (and the difficulty that we still have ensuring that UK views carry appropriate weight in the EU institutions);
- The uncertainties over Basel II, following the US decision to postpone implementation;
- The upheavals in the retail financial sector that are likely as a result of Sandler, Turner et al.;
- The opacity of the hedge fund/private equity sector;
- “Spitzer risk”, particularly (but not exclusively) in the insurance sector;
- Market structure issues (at both the front and back ends);
- Corporate governance, transparency etc;
- Technology, e-finance, identity theft etc; and
- AML and terrorist financing.