

CSFI

CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

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To: Members of the CSFI Advisory Council
cc: David Lascelles, Senior Fellow
Jane Fuller

From: Andrew Hilton

5 December 2007

Meeting of the CSFI Advisory Council:
Held November 12, 2007
at the City Club

A meeting of the Centre's Advisory Council was held on November 12, under the chairmanship of John Plender. A list of those participating is given as Appendix I.

This is a regular opportunity for friends and sponsors to tell us what we are doing wrong (and right), and to give us more or less specific advice on our programme for the next six months or so. There is always a lively discussion, which is certainly valuable for those who participate. However, in this Note, I intend to concentrate on the issues that people feel we should cover. Most of these came out of the meeting itself, but some were contained in e-mails or came out of subsequent conversations. There are also some carry-overs from the preceding Advisory Council meeting. We won't follow this agenda slavishly, but I hope that, by the time of the next Council meeting, we will have covered 60-70% of the topics.

A Global liquidity squeeze: John Plender described this as the "biggest maelstrom" in a very long time, and it inevitably dominated the discussion. Of course, the difficulty is how to find some way of adding value to the debate. Among the angles that we could look at:

- Can we continue to allow banks to grow? What does it really mean to be 'too big to fail'? Can banks be 'too big to manage'? Have we wildly underestimated the 'diseconomies of scale' in banking? (Equally, can one defend bigness?)

Potential speakers might be hard to come by, but Geoffrey Owen's group at LSE has been looking at the diseconomies of scale. Other names mentioned included John Stopford (LBS), Gary Hamel (a global guru, who happens to be a visiting professor at LBS), Jeremy Isaacs (Lehman Bros.), Phil Rivett (PwC), Philip Augar etc etc. Perhaps even Luqman Arnold (if he isn't too busy). Goldman Sachs has also done relevant work on the underperformance of FTSE 100 firms in the financial services sector.

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- *Can we rewrite the Tripartite Arrangement, which allocates responsibilities among the Treasury, BofE and FSA (even though it has already been rewritten at least once)?*

There was widespread concern that the collegial process had been politicised by the Treasury. The Arrangement “gets torn up in a crisis”. There was, however, a feeling that a CSFI initiative in this area (perhaps even a small working group) could be useful. There are boundary issues, moral hazard issues, contagion issues etc. It was suggested that a potential speaker might be Matthew Bullock (ceo of the Norwich & Peterborough building society, ex-Barcap).

- *Should regulators shift their focus from capital to liquidity? (See also the discussion on ratings agencies.)*

It was recognised that this is more difficult than it appears. However, David Green pointed out that the BofE actually surveyed the banks on their liquidity as long ago as 1991: “they knew”. Plus, as someone else said, the definition of a financial crisis is a change in liquidity, capital is secondary.

- *The role of the ratings agencies. Are they fit for purpose? Are they too conflicted?*

It was pointed out that the agencies are currently being looked at *inter alia* by McCreevey, IOSCO and the US House Banking Committee. They are in trouble. The issues they face include:

- exactly what they are rating;
- whether (or to what extent) they are conflicted;
- whether it is possible to encourage competition; and
- whether they should be regulated more closely.

It may also be worth asking whether they should rate liquidity (as we suggested in a very early CSFI paper¹).

- *Will Basel 2 make it worse?*

Jane Fuller pointed out that Basel 2 emphasises capital over liquidity, and that it gives new official status to the role of the ratings agencies.

- *The problems of conduits/SIVs, and whether they should be allowed to remain off-balance sheet.*

¹ “Liquidity ratings for bonds” by Ian Mackintosh, CSFI, January 1995.

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It was felt that not enough is known about how conduits work – or about the conditions under which they revert to (or can make demands on) the sponsoring

bank. There was a sense that we really didn't put the lessons of Enron into practice. There is also a concern about differential treatment of SIVs under different accounting codes.

- *The role of the press in the Northern Rock affair.*

Here, opinion was polarized. The majority view was that the BBC, FT etc did their duty. However, a significant minority felt that the BBC, in particular, trivialised, sensationalised and exacerbated the problem. Linked to this is a broader issue of transparency: is more (and more timely) information always a good thing? In the case of a banking crisis, does greater transparency mean that the BofE's lender of last resort role is finished? Does the LOLR role require secrecy?

It would also be worthwhile looking at the macroeconomic impact likely to be caused by disintegration of the leveraged credit that the sub-prime sector supported. I realise that we are not best-placed to cover macroeconomics, but the removal of credit from the global economy is a huge issue for the banks. A major proponent of this view is Goldman.

B Sovereign wealth funds: While direct governmental intervention in the global economy may be decreasing, intervention via SWFs is increasing – *vide* ADIA's investment in Citigroup. The danger is that this will be seen as politicising investment decisions. As one participant said, the potential is for "a perverse combination of market power and non-economic goals". Obviously, different SWFs have different strategies, different types of behaviour, and different goals – and a *tour d'horizon* of the SWF universe would, therefore, make sense.

Among the names of potential speakers were Gerard Lyons (Standard Chartered) and Michael Gordon (chief investment officer at Fidelity).

C Developments in the exchange space: Clearly, there is a lot going on – at both the front end (Turquoise, Dubai, Qatar, Chicago etc) and back end (BOAT etc). Each would be well-worth a mini-series, perhaps commencing with *tours d'horizon*. On the back end issues, we already have agreement in principle for Alberto Giovaninni to speak; we need someone with similarly impressive credentials at the front end.

D The Monoline insurers: Although John Grout subsequently sent me an email pointing out that (in his view, at least) the monolines are not a major force in the UK, and that the problems associated with them are limited to the US muni market, there was a

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feeling that we should look at their role. They are certainly a little understood element of the insurance market.²

E **Other issues:** As noted, a number of other issues have been raised, either prior to the Advisory Council meeting or subsequently. The following found their way into the pile on my desk:

- **Carbon/emissions trading:** There is a strong appetite for more of this. Two suggestions (from Etienne Pollard):
 - that we should get Ian Johnson (who has already spoken once, on carbon trading) to talk about his World Bank experience setting up the first carbon funds; and
 - that we should get Paul Dickinson (of the Carbon Disclosure Project) to discuss his experience in getting listed companies to report their carbon emissions – ie to use shareholder activism as pressure to cut carbon emissions.
- **OpRisk insurance:** Philip Warland suggests that we should pursue this further in the light of Shirley Beglinger's recent paper. The example of ICI Mutual – a US insurer that provides coverage to mutual fund managers – would be relevant.
- **Solvency 2:** This is clearly the next Big Idea in the insurance sector – and the most important European initiative following implementation of MiFID and the CRD.
- **'Non-dom' status:** There is a lot of concern that the government simply doesn't understand what it is doing in this area. Martin Day 'volunteers' Farrer's tax partners, John Carrell and Diana Davidson, as speakers. (John Chown would be another obvious choice.)

Among the carry-overs from previous Advisory Councils, I should add:

- the future of class action suits in the UK (there is a class action suit against Northern Rock, being organised by David Greene at Edwin Coe);
- the impact of fair value accounting;
- Islamic finance (particularly now that Deloitte has appointed its own in-house Shari'a expert); and
- the impact of CFIUS on US competitiveness (Tim Spangler has offered help).

AH/rd

² I am sure John would be happy to share his thoughts. His email is jgrout@treasurers.org.

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Appendix I

**Meeting of the CSFI Advisory Council: Held on Monday, November 12, 2007,
at the City Club, 19 Old Broad Street, London, EC2N 1DS, from 6:30-8:15pm
under the chairmanship of John Plender.**

Chair

John Plender

Financial Times/CSFI Governing Council

CSFI

Andrew Hilton

Director

David Lascelles

Senior Fellow

Rhiannon Davidge

Sam Barber

Programme Coordinator

Members

Martyn Baker

City of London

Alan Brener

Abbey

Saxon Brettell

City of London

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Richard McManus

PA Consulting

Nick Miller

Reuters

Lyndon Nelson

FSA

Vicky Pryce

DTI

Mark Robson

Treasurer, LMH, Oxford/CSFI Governing Council

Clifford Smout

Deloitte

James Woodhouse

Accenture

Guests

Malcolm Aish

Open Europe

Keith Boyfield

IdenTrust

John Bullard

Complinet

Peter Elstob

University of Cambridge

John Forsyth

Fuller Analysis/*Financial World*

Jane Fuller

Martin Hall

FRC

David Green

Equitas Trust

Sir Adam Ridley

FRC

Paul Seymour

London Business School

John Stopford

Halsey Consulting

Philip Warland