

CSFI

CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

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To: Distribution

From: Andrew Hilton

July 23, 2003

Advisory Council Meeting: July 10, 2003

A meeting of the CSFI's Advisory Council was held at the City Club on the evening of July 10, under the chairmanship of John Plender. A list of those attending and an agenda are given as Appendix I.

I CITY COMPETITIVENESS

After Hilton had briefly summarised the Centre's work programme, Lascelles turned to his recent report on City competitiveness. What should we do with a report that attracted a good deal of press coverage (some of it, in the eyes of the Corporation at least, controversial)?

Lascelles suggested that the hook for future work should be the finding that "the main swing factor" against London was the perception of an unresponsive government – that "the other end of town" is indifferent to City demands, and that it does not "box clever" in Brussels. He suggested that we get someone to defend the governments approach – and, lo, it is being done. Shortly after the Council meeting, we received word from the Chancellor's office that Paul Boateng, chief secretary to the Treasury, is willing to address this issue – something for which we are very grateful. Details will be circulated as soon as we have set a date. (Probably December 11.)

The other issues that, in Lascelles's view the City competitiveness study raises include:

- the role of technology in forcing firms to centralise their operations (we believe that London benefits from this);
- whether it is possible to establish in Brussels that London's lead in the financial services sector marks it out as a "special case", such that the EU should not even try to apply to it "one-size-fits-all" norms that are more appropriate to second and third-tier centres like Frankfurt or Milan;
- the costs and benefits of flexible labour legislation (Hilton pointed out that many respondents seemed to feel that the greater ease and lower cost of laying off workers in London was an enormous competitive advantage for London, even though in the short term it may mean that London bears the brunt of job cuts);¹ and

¹ The Incomes Data Services may have information on this; we will pursue.

- the competitive threat posed by New York (the Corporation study makes it clear that it is NY, not Paris or Frankfurt, which is the only serious competition to London).

Given the last point, Murray felt that we should look at the different directions that regulation is going in on each side of the Atlantic. In the UK, the pressure is to rationalise and centralise; in the US, there is what he called “political competition”. He particularly pointed to the growing role of the states’ attorneys-general (Spitzer *et al*). Hilton added the newly predatory role of the CFTC, which is moving into new areas.

There was also a sense that we should look further at the potential “pollution” of the wholesale market by the “parochial” ethos of retail regulation. It was felt that this did not come out as clearly as it should have done from the competitiveness study.

As for the retail financial sector, the main issue there (it was felt) is how to re-establish trust with the consumer. Is this a role for the regulator? Or does it depend on the industry itself?

There was also discussion of what the imminent “regime change” at the FSA would mean in terms of regulatory style. What will the McCarthy/Tiner team feel its mandate to be? On this:

- Pickering suggested that the new team should concentrate on financial education (though McDonald argued that the FSA cannot be expected to compensate for the appalling lack of financial literacy in the general population);²
- Tyson-Quah suggested a rationalisation of regulatory reporting requirements using XML standards (she suggested we should look at the US OCC as a model);³
- Monro-Davies suggested that insurance will be (or should be) close to the top of the agenda; and
- Barber suggested further work on pensions (though he argued there will never be political pressure for radical change until MPs’ pensions are put on a money purchase basis, exposing them to the vagaries of the equity market like most other folk).

II BASEL

The next general issue was Basel 2.

Hilton began by saying that we have agreement in principle from the OCC to put someone up to discuss the problems of “doing Basel on the ground” – ie the practical issues for regulators posed by the new rules.

There was also support for getting someone over from the Accord Implementation Group to discuss how regulators are expected to implement the new rules. In addition:

² We are talking with ProShare about a round-table on this, probably in September, possibly with Anna Bradley as well.

³ Griffiths said the FSA is about to issue a CP on reporting data; perhaps this would be the peg for a round-table.

- Hilton felt that we should look at differences between CAD 3 (or whatever it is called now) and Basel;
- Milne suggested we should look at the concept of “permanent partial rollout” – which seems to suggest that Basel might only apply to “bits of a bank”; and
- Davies was concerned about certainty – Basel 2 will cost about US \$100 million/bank, and “you need to know if you will be compliant if you do a certain number of things”, otherwise “there is no business case for it”.

Given recent comments by US regulators, it may also make sense to look at “Basel 3” – which appears to be just around the corner.

III PENSIONS

Third issue was pensions – with a plea not simply to rehash the problem.

Hilton emphasised the quest for solutions. He also urged that we should look at the possibility of “depoliticizing” how we handle the pensions issue – perhaps using the depoliticization of monetary policy as a model.

There was considerable scepticism about this, but McDonald emphasised that The Netherlands and Sweden have both (largely) depoliticized their pensions problem – and she said, there is already an all-party consensus on some other important issues. So, why not pensions? In her opinion, the first step towards any solution is to get rid of the pension credit; instead, she said, there should be a “reasonable” state pension that could be built upon.

McDonald would also like us to look at the Dutch system. Would it be possible to “transmute” existing UK company pensions into sector-wide schemes for employees and the self-employed? (In The Netherlands, she pointed out, sectorally-based occupational pensions now cover over 80% of adults.)

IV CLEARING & SETTLEMENT

Turning to clearing and settlement, Hilton said he felt a strong need for a presentation by someone who is sufficiently familiar with all the various initiatives to provide a *tour d’horizon* of what is going on.

Bell told the group that Sir Andrew Crockett (latterly of the BIS) has agreed to produce a follow-up to the recent Group of 30 study on C&S (which produced 28 key recommendations). Perhaps he would agree to talk to us about this. Tyson-Quah suggested we combine it with a look at the SwiftNET initiative, based on interoperability.

Elderfield said there are really three issues to look at in this area:

- Developments on the ground – Crest/Euroclear, LCH/Clearnet etc. We need to look at the business models that are currently emerging.
- Efforts by industry to overcome barriers to consolidation - here, the issue is whether interoperability is really feasible; plus we need to look at legal barriers. (He suggested the BofE’s legal adviser in this area.)

- Policy issues – notably the standards being championed by different regulators. Will there be an EU directive on C&S? The Commission will publish a feedback paper in the Autumn, he said, and a directive is possible in 2005/06. Plus, the French (through BNP Paribas) have a clear preference: they want core C&S to be tightly regulated.

On the last point, Milne added that EU competition authorities are also looking at the C&S area.

V EU LEGISLATION

The next issue raised was the EU's Financial Services Action Plan.

Plender suggested that we should look again at the Takeover Directive – which is “back in the melting pot” after 13 years. Elderfield said that, in addition to takeovers, two hot issues are:

- the ISD; and
- the Transparency Directive (on which the Stock Exchange has recently issued an important paper).

He said that next April's Parliamentary elections represent a cut-off date; there will be great time pressure to advance both of these ahead of the election.

Plender took Lascelles's earlier point: the Takeover Directive is a “lowest common denominator directive” that should really be irrelevant to the City. The danger is that we will end up with a “second-rate directive to replace a time-honoured voluntary system”.

Turning to the draft European Constitution, Lascelles said how important it is to clarify what (if anything) it means for the City. For instance, will it change our employment practices?

VI HOUSING

The next issue for discussion was housing finance.

Hilton said that Professor David Miles (who, with Kate Barker, is doing work for the Treasury on various alternatives to the present system) has agreed to speak at a round-table, following submission of his interim report in November.

Plender and McDonald emphasised the various housing finance models in Continental Europe and the US – but also the difficulties in getting “from here to there”. Keating also emphasised the problems in moving to a securitized model – notably difficulties in changing title in the UK and the stamp duty issue. “We need to talk about modifying the legal, tax and accounting systems so that residential mortgages can be used as collateral for repo.”

Davies suggested that before we can really do anything in this area, we need to “invent the callable debt market; the US has it, but we don't”. Markets exist in the US, but not here – hence the assets are unhedgeable. He emphasised that we should not be keen to transfer risk from the personal sector to the banks unless there is a hedging mechanism.

Clegg said that he was talking to Miles as both Abbey National and ALMA (the Asset & Liability Management Association). The key issues for him are:

- Where fixed rate mortgages exist in Europe, there are enormous barriers to refinancing. The cost of refinancing in the US is very low – so low, he said, that the average life of a (notionally 30 or 35 year) fixed rate mortgage is just two years.
- There is a customer education problem. It is not clear that there is a market in the UK for US-style fixed rate mortgages. What the UK consumer wants is the lowest possible coupon.

Davies agreed; we have to wait for people to learn from their mistakes. Keating added that long-term fixed rate housing finance has contributed greatly to the weakness of Continental banking systems. As Barber put it, should we copy a flawed system? (Is it a flawed system?)

Bell emphasised that (partly thanks to Fannie Mae and Freddie Mac) “refinancing in America takes just a couple of minutes”. Presumably, given their problems, Gordon Brown would not permit creation of US-style Fannies or Freddie’s, so “what is the CSFI’s angle?” (Is that clear: should there be a UK Fannie?)

VII CRM/IAS

The next issue brought together corporate reporting and international accounting issues.

Plender argued that the pressure for fair value accounting is very important. Murray agreed – but warned that the subject is “too vast”.

Plender insisted that the people running UK companies today are unaware of what will hit them around 2005 in the form of international accounting standards. He urged us to approach Mary Keegan for a summary of what is going on, and a discussion of the implications.

Bell agreed that the insurance industry is particularly exercised about fair value accounting. He said the Group of 30 is doing a big study of what fair value accounting will mean for different financial instruments – and warned that the answers are not always obvious. A role for the CSFI would be to look at what fair value actually is, where its application would lead and what the issues are – particularly for insurers.

Hayward wondered whether the second thoughts about fair value accounting might not suggest that “financial reporting has reached the end of the road”. It was, he said, “a good closed system”. But business is now too complex, and there is a need for more useful predictive tools. He pointed out that “historical cost accounting was wrong, but we knew it was wrong”. We don’t have a clue about fair value accounting.

Keating went further. For him, “fair value accounting is a misunderstanding of modern finance” (but he did not elaborate).

Midgley suggested that we should look again at FRS 17. The accounting industry has not explained well that, using FRS 17, “the numbers will be very different from what they were

before”. As Plender said, FRS 17 may change accounting from “deterministic” to “probabilistic”. Clegg suggested that the CSFI should try to do something on this together with ALMA or GARP.

Thomson warned that FRS 17 and mark-to-market are the “mantras of the moment”. As he pointed out, the liquidation value of a company is not the mark-to-market value of the day before. Keating noted that the Dutch are producing a white paper on fair value; they have done more on this than we have.

Murray emphasised that the issue is transparency. “The traditional audit model is so blunt; it adds nothing to transparency.” We really need to rethink the model.

VIII MONEY LAUNDERING

On money laundering, Hilton explained that he had so far failed to set up the working group endorsed at the last advisory council – despite widespread support and an agreement in principle with APCIMS. It remains worth pushing for.

Owen pointed to a recent KPMG report (lead-authored by Alan Bates) which has confirmed some of the problems with the NCIS reporting system that had prompted our interest in the first place. This is worth following up. He also said the Treasury is working on a money laundering strategy paper. There is, without doubt, an awareness of the problem at senior levels.

Owen also noted that the Assets Recovery Agency is now up and running, extracting money from criminality. Perhaps we should look at this.

Davies expressed a very general complaint about AML initiatives: none of this has much to do with terrorism – “because terrorists are not financed by dirty money”. Keating added that the cost of AML legislation is now beginning to have an impact on structured finance: certain arrangements are no longer viable.

IX INSURANCE

Turning to insurance and risk transfer, Dowd said that the key question is whether you can build a primary market. Is there enough appetite from banks to get involved? What kind of risks can be transferred? And what risks can insurers take on from banks?

Keating observed that the FSA thought credit risk was with the insurers: “it isn’t”. The credit derivative market has “probably” shifted it to the smaller banks. Indeed, he said, “the insurers may have been pricing (risk) better than people realise”.

X RETAIL BANKING

On the issue of the future of the retail bank, Lascelles pointed to work by Accenture and British Telecom on the potential for reviving branch banking. Is it a fad? Or will it take off? We are organising a round-table on this.

XI AID

On the issue of aid delivery, Hilton explained a concern that he has had for some time – that the structure that we have developed for aid delivery around the world (based on the World Bank, its clones and government departments) is excessively “top down” and enormously wasteful. Money gets poured in the top of the aid machine; much gets siphoned off for school fees, first class travel, pensions etc. and months later what is left filters through to those who need it. Is it possible to envisage a bottom-up approach, perhaps based on the (admittedly flawed) microfinance model?

The answer is Yes; but how could the CSFI tackle the issue? We still hope that Clare Short will come in the Autumn to discuss the lessons she draws from her time at DfID.

XII OTHER ISSUES

Finally, Plender asked Bell (who has been very supportive of the CSFI’s embryonic presence in New York) for his thoughts.

His ideas included an advisory board for the NY CSFI. On issues that the Centre might look at, he suggested what happens to financial institutions in a sustained world of zero inflation. Although we have looked at this before (with Roger Bootle), it is well worth revisiting. In the US, for instance, returns on money market funds may soon turn negative; what will that do to saving habits? (Milne said that the ESRC also has a major programme in this area; it would be interesting to see what it says about financial services.)

In addition to the topics covered at the Advisory Council meeting itself, several people who couldn’t attend sent in suggestions. Among those which are worth a look:

- Mark Edwards (Accenture) suggested that there are changes afoot in the executive pay area. Are we seeing the start of a realignment to historically-sustainable boss:worker ratios?
- Ruwan Weerasekera (Accenture) wondered whether we should look more at the operational risk associated with outsourcing, particularly by second-tier banks. (We have already looked at outsourcing, but this would be a new wrinkle.)
- Mick McAteer (Consumers’ Association) aimed us in the direction of what he called “21st century regulation”. He argues that the Equitable Life case has demonstrated the structural flaws in our regulation and the conflict of interest inherent in FSA’s statutory objective to maintain market confidence and protect consumers. “We need a regulatory regime which appeals to ordinary consumers, not ivory tower regulators.”
- Sir Adam Ridley (LIBA) emphasised the importance of the European Constitution: “I would suggest that this should be your top priority”.

CSFI Advisory Council meeting
To be held on Thursday, July 10, 2003 at the City Club (Garden Room),
19 Old Broad Street, London EC2N 1DS from 6.30 pm – 9.00 pm.

CSFI

John Plender	Chairman, Advisory Council
Andrew Hilton	Director
David Lascelles	Co-director
Fleur Hansen	Manager

CSFI Members

Geoffrey Bell	Geoffrey Bell & Company
Andrew Campbell-Hart	FSA
Simon Card	BT
John Chown	Chown Dewhurst
Richard Clarke	PricewaterhouseCoopers
Christopher Clegg	Abbey National
Brandon Davies	Barclays
Mark Davies	Accenture
Adam Djanogly	Fitch Ratings
Victor Dowd	Aon
Matthew Elderfield	FSA
Dilwyn Griffiths	FSA
Stephen Grainger	CRESTCo/Euroclear
Martin Hall	Finance & Leasing Association
Jim Holdgate	EFG Private Bank
Rick Murray	Swiss Re
Martin Owen	FSA
Tony Thomson	PA Consulting
Roderick Walker	City Consultants

Guests

Jonathan Barber	SERM
Francesco Burelli	Edgar, Dunn & Company
Jonathan Hayward	Independent Audit Limited
Tim Hoad	IntangAbility
Con Keating	Finance Development Centre
Benedikt Koehler	
Oonagh McDonald	
Gordon Midgley	Investment Management Association
Alistair Milne	Cass Business School, City University
Robin Monro-Davies	
Craig Pickering	Money On-line Education

Timothy Spangler
John Thirlwell
Kathleen Tyson-Quah

Berwin Leighton Paisner
ORRF
Granularity

CSFI ADVISORY COUNCIL MEETING
July 10, 2003 from 6.30-9.00 pm

AGENDA

Report on activities (AH)

Follow up to existing work:

1. City competitiveness study (DL) (One suggestion: "If you had one wish...")
2. Basel 2
3. Pensions (solutions; not a restatement of the problem)
4. Clearing & settlement

Other issues:

5. Takeover directive, CAD 3 (or whatever it is called now) and other FSAP legislation
6. The draft European Constitution and the City: will it have an effect?
7. Housing finance – Miles *et al.*
8. Corporate reporting issues (JP)
9. Money laundering initiatives
10. International accounting issues (JP)
11. Insurance and risk transfer / mitigation
12. Retail banking (DL)
13. Aid delivery (AH)
14. Trustee liability restrictions
15. Ethical issues

The changing role of the banker in City life (DL)