

Financial *Innovation*

Bi-monthly newsletter from the Centre for the Study of Financial Innovation Issue no 26 January 2003

From the director...

At the end of November, the Centre's Advisory Council (under the chairmanship of John Plender) met to discuss what we should be looking at in the next few months. Among the Council's main concerns:

- Sarbanes-Oxley (what is the value of a US listing?);
- Basel 2 (or should we be looking at Basel 3?);
- threats to London's competitiveness;
- implementation and enforcement of the FSAP;
- pension issues (Maersk etc.);
- IAS 39 (the danger of unintended consequences);
- the corporate bond market;
- a health-check on N2+1 (made more relevant by Howard Davies's decision to move on);
- a cost/benefit analysis of the war on financial crime;
- regulating the raters;
- gambling and insurance; and
- the broader threat to the insurance market.

Of these, there is tremendous concern about Sarbox, though there is also great uncertainty. The Basel issue won't go away: Charles Taylor's paper (see below) has sparked a wider discussion of whether it is stoppable. Most say No - but most also agree that whatever benefits there were from the Basel process have already been realised. It is just costs from here on in. Of the other issue-areas, it is worth stressing the perceived danger (to the City, to UK plc etc.) that the FSA is moving to excessive micro-regulation. Not everyone would agree; consumer groups, for instance, might argue it has been captured by practitioners. But it is worth remembering that a good regulator does not stop institutions failing; its priority is to stop the system failing (and to protect depositors and policy-holders from the direst consequences of their folly). AH.

More staff changes: At the end of the year, Alexander Evans left, to go to the Policy Exchange (the New Tory think-tank), where he will be in charge of the globalisation programme. He was with us for almost two years, and we wish him well. Most of his portfolio will be taken over by Fleur Hansen (though there may be a little restructuring around the edges). Fleur – an Oxford-educated Tasmanian – has worked in the City for a couple of years, and we are lucky to have her. Alexandra Urry has also stepped down as Administrator, which provides the opportunity for a modest restructuring of the Centre's operations.

Publications

Several publications since our last newsletter (some of which have already been the subject of CSFI round-tables). All of them are available through Central Books. Phone: 0845 458 9910. Web: www.centralbooks.co.uk.

- *Clearing and settlement: Monopoly or market?* (October 2002) By Tim Jones. £25/\$40/€45. This is a plea (by the former head of retail banking at NatWest, and developer of the Mondex card) for bringing competition to the C&S space. There is no reason (he says) to believe that FX C&S needs to be, as at present,

Forthcoming Diary Dates Round Tables

January 8

High tech crime: A round-table discussion with Tony Neate, Industry Liaison for the National High Tech Crime Unit (NHTCU).

January 13

OECD - tax issues: A round-table discussion with Jeffrey Owen, head of OECD's Centre for Tax Policy and Administration.

January 21

FSA Practitioner's Panel: A round-table discussion with Donald Brydon (AXA).

January 27

The security issues around m-commerce: A round-table with Lorenzo Valeri (RAND Europe).

Please be advised that all dates are preliminary until invitations are sent (www.csfi.org.uk) carries the latest schedule.

CSFI
Centre for the Study of
Financial Innovation

Many thanks to mi2g for coming on board as a sponsor of the CSFI, and also to Chown Dewhurst LLP, the Canadian High Commission, Moody's Risk Management, JP Morgan Chase, HSBC, AVIVA, Royal Bank of Scotland, Swiss Re, Aon, City Consultants, Reuters, Halifax and the FLA for renewing their support.

a monopoly – either nationally or cross-border. Indeed, it is clear that monopoly has pushed the price up and service levels down – while, in the payment card area, the Visa/MasterCard duopoly has held costs down and stimulated competition. From this viewpoint, CLS Bank is an expensive solution that is far less satisfactory (and more dangerous) than competing systems would be.

- *The future of financial advice in a post-polarisation marketplace.* (November 2002) By Stuart Fowler. £25/\$40/€45. This report (produced with support from Accenture) is a joint effort: though written by, and largely representing the views of, Fowler, it also picks up on the opinions of a working group that met during the summer. It is a comprehensive look at how financial products need to be structured, sold and regulated if the government's goal of boosting savings is to be achieved. The key is to break the dominant commission-based revenue model, which acts as a monopoly keeping financial advice expensive and opaque. In addition, the report recommends much clearer product labelling: products must do "what they say on the tin".
- *Capitalism without owners will fail: A policymaker's guide to reform.* (November 2002) By Robert Monks and Allen Sykes. £25/\$40/€45. (Also published in the US by the New York CSFI.) This important paper – which carries forewords by Henry Kaufman and Sir Brian Pearse – is an attempt to produce a comprehensive solution to a problem everyone recognises: managers have taken to themselves powers that really ought to be exercised by a corporation's owners. Unfortunately, "ownership" has become an almost abstract concept, since most beneficial owners now invest through institutions who connive with management in the shift of power that has taken place. Monks and Sykes argue that the key to reform is to require institutions to act solely in the long-term interest of beneficiaries, and to reinvigorate the concept of independent non-executive directorship.
- *Who speaks for the City? Trade associations galore.* (November 2002) By David Lascelles and Mark Boleat. £25/\$40/€45. There are over 50 trade associations in the City, purporting to represent one or more slices of the financial pie. Their combined budget is around £150m. Are there too many? Or too few? Does the City spend too much on TAs? Or (given the importance of the issues) too little? Should there be rationalization? Or would it make sense to let a thousand flowers bloom? And what about the European dimension? Is London's voice heard in Brussels? This is a much ignored area, but clearly one that merits a closer look. Broadly, Lascelles and Boleat think we have got it right – though there may be room for rationalization around the edges. And certainly there is need for more and better cooperation.
- *A New General Approach to capital adequacy: A simple and comprehensive alternative to Basel 2.* (December 2002) By Charles Taylor. £25/\$40/€45. (Also published in the US by the New York CSFI.) This paper, written by the former director of the Washington-based Group of 30, offers a

comprehensive alternative to the evolving nightmare of Basel 2 – which, it is now widely agreed, is too prescriptive, too focussed on ends not means and too far short of what is even now best practise in the risk area. Crucially, Basel 2 also undermines bank governance by taking away from managements decisions that ought to be theirs. What it offers is an update of the pre-commitment approach of Kupiec and O'Brien – but with a new wrinkle. Taylor proposes that regulators should set a "loss parameter" for each bank that would link the capital and loss thresholds that they will themselves nominate. This is a powerful tool, and it opens the way to much more markets-friendly regulation. Is it too late? Possibly; but it is worth remembering that Basel 2 has already had a huge positive impact – forcing banks to think about risk much more systematically. From now on, costs are bound to outweigh benefits.

- *The new world of European e-finance.* (December 2002) £40/\$65/€65. This 160-page book (which has prefaces by Sir Eddie George and Frits Bolkestein) is the first comprehensive look at what is going on in the European e-finance world since the bursting of the tech bubble. It includes contributions by various authors on key national markets and on the main drivers for change – including m-commerce. We believe it will become an invaluable reference work. AH

Round-tables

The independence of analysis. With John Plender (*Financial Times*), Roger Bootle (*Capital Economics*), and Nick Antill (BG Training). September 5, 2002.

Is the furore over equity analysis in the US (Grubman *et al.*) a passing fad, or should it scare us in Europe as well? The FSA purports not to be worried about the UK, but both Plender and Bootle had serious concerns. Key points from a lively discussion:

- In the 1990s, City analysts undermined central bankers by making it impossible for them to prick the asset bubble they all saw coming – meaning that, when it burst, the damage was that much greater.
- In the end, the traditional model of integrated investment banking means that analyst research is always a loss leader for corporate finance.
- Today, "no exogenous shocks are permitted when it comes to corporate information" – which means analysts and companies are in cahoots.
- The quality of tied City analysts, on average, leaves a lot to be desired – and it leaves the vast bulk of companies untouched.
- It is hard to avoid pressure from above given where bonuses come from and which parts of the business make money.

One result of all this is to inhibit growth of a US-style shareholder culture. Plus, it is a monumental waste of

resources. What can be done? Well, a prolonged bear market may change things – and it may thin out analyst ranks on its own. Buy-side institutions will also be a lot more hard-nosed about paying for bundled research they don't need. There will also be continuing pressure to change the way brokerage and research are paid for – but don't hold your breath. The market for untied research is, and will remain, tiny – absent some kind of mini Glass-Steagall. One final thought: hedge funds may prove a healthy development – making analysis less dependent on the equity cycle and encouraging a genuinely two-way market. AH.

The role of the FSA's Consumer Panel. With Colin Brown. September 18, 2002.

Brown's good – but that doesn't necessarily make him popular in the City. Nor should it; his remit is to make sure the FSA is accountable to the consumer interest. He heads a 13-member (part-time) panel, supported by a small secretariat, which provides a consumer input into FSA policy-making. Practitioners tend to argue consumers have too loud a voice; but, as Brown pointed out, of 700 responses to CPI21, only two came from consumer groups. Hence the need for the consumer panel to have a modest research budget to back up its submissions. Europe is also an issue. Directives from Brussels are complex and rarely understood by consumers. But they have enormous implications and it is crucial that the consumer interest is represented.

Perhaps surprisingly, the discussion was positive: the FSA has not been colonised by the consumer lobby, but the consumer panel has certainly made it more accountable. And there was agreement Brown had done a good job. Nevertheless, there was the perennial worry about a drift of regulatory style from retail to wholesale markets – and the consumer interest has certainly had a role in that. AH/AE.

Current issues in housing finance. With Mike Coogan (Council of Mortgage Lenders), John Wriglesworth and Phil Jenks (Halifax). October 1, 2002.

Housing is a fraught area in the UK – and it has become even more so since this round-table. But it isn't as obvious as many commentators suggest. As Wriglesworth pointed out, even something as simple as house price inflation doesn't necessarily mean what the press says it means: different sources calculate figures in different ways (asking prices vs. contract prices, for instance), and at different dates (acceptance vs. completion). The effect can be striking – the bubble can have burst, while figures say prices are still rising. Plus, what bubble? There is no bubble in large parts of the UK, where the problem is often one of unused housing stock. Plus, with interest rates at a 40-year low, and the lowest spreads over base rates in Europe, is house price inflation

really such a problem? After all, prices have not risen as fast as interest rates have fallen.

That said, it is clear that housing finance poses all sorts of challenges, and opportunities. After all, it really is “finance for life”, and it seems obvious that there should be flexible mortgage products that automatically slide into equity release. Problem is that innovation in this area has had a pretty dismal record – not just on equity release; shared appreciation mortgages have also been very controversial (particularly where house prices have risen so fast). And, of course, there is the regulatory side. Regulation in this sector has had a chequered history, not least because data on mortgage brokers and advisors has tended to be pretty thin. But the self-regulatory approach, through voluntary mortgage codes, had a lot of merit – particularly coupled with the ombudsman scheme. Whatever, statutory regulation is just around the corner – not just because of the FSA, but also because of Brussels (which could have implications for provision of flexible mortgages). AH.

Prospects for the EU's Prospectus Directive. With Tom Troubridge (PwC), Kevin Desmond (PwC) and Lachlan Burn (Linklaters). October 4, 2002.

This is a particularly vexed issue for London – and it was a tough round-table, raising lots of hard questions. The fundamental problem is that the directive takes UK regulation in a new direction. It will raise costs for UK public companies, will threaten AIM and could undermine the eurobond markets. It will also cause confusion for investors, and will tend to undermine the UK's reputation as a “first division”, high quality market. So, why is Brussels pushing ahead so hard? One reason is precisely because the rest of Europe is so far behind – on listing, for instance. True, the directive is just about admission to trading, but, without an appreciation of how listing works in the UK, it can do considerable damage to a system that presently works pretty well.

The speakers were concerned. London has “lost Round One”, but it could still take the initiative on listing – and on the transparency directive. There is officially not much room for radical change, but (as of the discussion) CESR had barely spoken. The real problem is that so many directives are coming down the pike – each of which implies trade-offs against the others – that it is very hard for the UK to fight its corner effectively. Nevertheless, this particular directive is important – and potentially very damaging. It takes Europe in the direction of an SEC-style regime, with all the filing costs that entails. There have been attempts by the Commission to respond to London's concerns (particularly on smaller companies), but even the latest versions will restrict where companies can issue – and that could hurt London. Getting changes, however, is especially difficult because the prospectus directive is just one part of a broader exercise. (This is a crucial area, and one we must keep coming back to.) AH.

Joint Money-laundering Steering Group (JMLSG). With Ian Mullen (British Bankers' Association). October 7, 2002.

Strong attendance indicates just how important this issue and the JMLSG are. Mullen chairs the 16-member group, which represents banks, insurers, fund managers, IFAs and the professions (though there is recognition that money-laundering is just as likely to go on through betting shops, antique dealers and *bureaux de change* as through the formal financial sector). The emphasis tends to be on banking, and (said Mullen) the group's approach is risk-based. The first task of the JMLSG, as it is today, is to revise its guidance notes so as to give industry a better sense of where it stands. It is clearly a new world the banks are moving into. In the US, the Patriot Act, in the UK, the Proceeds of Crime Bill – both change the rules (and, in the case of the former, add an element of extra-territoriality as well).

No one disagrees with the JMLSG's motivation; we all deplore terrorism etc. But one issue that the discussion brought out clearly is proportionality. In 2001, 27,000 suspicious transactions reports were filed; in 2002, that will have jumped to 60,000. But what does NCIS do with this information? One participant suggested that it follows up (seriously at least) no more than a dozen of the leads it gets. Some cost/benefit analysis is surely due, because there really is a cost in terms of pushing up the price of financial services and excluding many at the margins of society. AH.

The Consumer Credit Act. With Jonathan Rees (DTI), Martin Hall (Finance and Leasing Association), Penny Boys (Office of Fair Trading) Eva Lomnicka (King's College) and Teresa Perchard (National Association of Citizens Advice Bureaux). October 15, 2002.

Why is the CCA being re-examined? Primarily because much of it predates the credit card industry. The original 1974 Act needs updating, and Labour made it a commitment (promising to tackle loan sharks in the process). The overall aim continues to be competitive markets and confident consumers. In July 2001 the DTI began a rolling review of the CCA, a review which should deliver a total makeover. In part, this is also being driven by developments in Europe, where a directive on consumer credit is being drafted. The EU's 1987 regime, which drew heavily from the UK Act, is being updated too – and whatever emerges will have implications for the UK. Hence the DTI review has two functions: to form the basis of UK legislative reform, and to develop a robust position to feed into Commission deliberations.

Many groaned at the prospect of rolling regulation – and there is a tremendous amount of new regulation on the way. Plus, the industry feels that the government's spin on consumer credit reform ("tackling loan sharks") trivialises

the task of modernising legislation that largely predates credit cards, and that doesn't presently address e-commerce.

The FLA worries most about the proposed EU directive, which could become a 'kitchen sink', as the Commission tries to provide something for everyone to get it through. Practical industry concerns include poor drafting, the attempt to impose 'best advice' on providers, laborious conditions for renewal/alteration of terms, and what appears to be a ban on cheap introductory offers. What of the present licensing system? The OFT thinks it works well – the challenge is to develop a passport that would work across Europe. Licensing is relatively cheap, and though human rights issues persist, most speakers saw merit in having 150,000 credit licenses out there, enabling consumers to draw on credit when they need it.

Consensus emerged on reform. But views on the scale (and purpose) differed across the room, with some advocating a stronger shake-up (and more interventionist approach) than others. Moreover, the spectre of an EU directive, however long in the making, ought to focus attention on the importance of a modernised framework for consumer credit regulation. *(A final thank-you to John Plender, who chaired this round-table, and to the FLA for sponsoring it.)* AE.

Challenges for UK regulation: the OECD's work on regulatory reform. With Rolf Alter (OECD). October 24, 2002.

Alter – who is deputy director of the OECD's public management directorate and head of the regulatory reform programme – is in a near-unique position to compare developed country experience of regulation across a range of activities. It is certainly a burgeoning area: Koizumi, for instance, sees Japan's "better regulation" programme as key to recovery, and many countries now accept that regulation can be key to attracting foreign capital. None of this is new to the UK, where we have more experience of the public/private regulatory interface than most – but the OECD has only just got round to doing its own review. (The US and Japan were reviewed a couple of years ago; Germany and France are scheduled for 2003.)

The OECD accepts that the UK has been a pioneer and has confronted regulatory challenges earlier than most. It has also promoted a more open model than in most other countries, with extensive debate about the issues. That said, there are changes afoot in the UK: the consumer voice, for instance, is heard more loudly. In general, the UK scores well. In the OECD's view, the FSA makes sense. The regulatory process is widely organized and open to stakeholders. Nevertheless there are areas for improvement – *ex post* evaluation of policies, for instance. The NAO does some, but a broader approach is needed. There is also a need to look back on the objectives and costs of policies over a longer period, say 20 years; one fear is that sometimes change hasn't been given enough time to settle down. AH.

Are quality investment solutions available to the “mass affluent”? With Graham Bentley (Selestia) and Andy Maguire (Boston Consulting Group). October 28, 2002.

Bentley was a late sub for Brett Williams, who pulled out on the day. But we didn't lose anything since he had been as closely involved in development of the Selestia model as his boss. And, in any case, the round-table quickly became a broader discussion of the economics of private banking – an area where Maguire (and BCG) have done a lot of work. A downside of that was that we skated over one of the more intriguing aspects of the Selestia model – the fact that it outsources much of its back office to South Africa (its parent is Old Mutual). The upside was that we could compare both theory (Maguire) and practice (Bentley). The main points:

- This is not an easy market for newcomers to break into, since reputation is so important: “no one ever went broke recommending Fidelity” – a message that IFAs take to heart even more as they became more answerable to the regulator.
- Although Sandler *et al.* place a great deal of weight on the IFA's role in providing a product for the investor, “over 90% of returns come from asset allocation, not stock selection” – which is where Selestia's model comes into its own. It includes a risk profiler, which builds an individual profile for each investor – and then maps that over to an “efficient frontier”, where the choice of funds is constrained in asset classes. Using the Selestia model, the IFA can provide individual investors with personal risk profiles and asset allocation that would normally be outside their competence. The result: better (or at least more predictable) returns, and a more bespoke service to clients.

But will it work? As Maguire pointed out, the economics of private banking are daunting. The average IFA probably cannot afford much more than half a day per client per year – and he often doesn't see the client's full portfolio. In his view, consolidation is key, and anything that permits the IFA to review the client's full portfolio is good news; only then can proper asset allocation take place. However, even with systems that permit consolidation (and then allocation), the actual face time required with the client is considerable – perhaps several hours. That is always going to be the big hurdle for any IFA-based system, but at least Selestia provides the adviser with a tool and with access to a range of competitive investments that will provide a defensible spread of risk. AH.

“Performance persistence in UK equity funds - an empirical analysis.” With Tim Giles, Tim Wilsdon and Timothy Worboys (all Charles River Associates) and Peter Andrews (FSA). October 30, 2002.

This was an important discussion on an important report, prepared by CRA's Three Tims for the IMA – important

because CRA/IMA's argument is one that a lot of people (including ourselves) have been reluctant to accept. The consensus (outside more self-serving corners of the fund management industry) has been that past performance is little guide to future performance, as far as fund managers are concerned – a conclusion that has been broadly endorsed by the FSA.

Not so, say the Three Tims. On the basis of a new 20-year data set (excluding trackers), and looking at persistence purely from the consumer's perspective, they conclude that “performance broadly persisted in UK equity-based unit trusts between 1981 and 2001”. As a result, choosing a top quartile fund, as opposed to (say) a bottom quartile fund, will on average improve an investor's return. That sounds pretty obvious – but it isn't. In fact, it is potential dynamite, and will (no doubt) produce a lot of head-scratching in academic and regulatory circles. There are problems: the report uses raw, rather than risk-adjusted, returns, which some have found controversial. But, broadly, the CRA report does what it says “on the tin” – it gives retail investors who have already decided to put their money into retail equity funds a reason to choose better-performing over weaker-performing funds. Equally interesting, the level of persistence and the length of the time it is maintained vary by sector. Over a longer term horizon, persistence is greatest in the UK equity income sector; in the short run, it is greatest in the small companies sector.

The caveat about raw and risk-adjusted results is important. But, within its carefully laid-down limits, the CRA report is an important piece of work, which the FSA (to its credit) is taking seriously. AH.

“The future of financial advice in a post-polarisation marketplace.” With Stuart Fowler. October 31, 2002.

This was a round-table on the recent CSFI publication on the future of UK financial advice, given Sandler, Pickering and CP121. Fowler's main points:

- Cheap and simple products are currently excluded, not just by regulation, but by the “business model monopoly” – ie. the commission-driven sales model. We have got to break the idea that remuneration has to be tied to the value of savings, rather than the value of the service.
- There needs to be a new, universal product description standard, which must be the responsibility of the manufacturer.
- That said, there also needs to be a culture of personal responsibility – or, as Fowler put it, “informed self-provision” which will permit individuals to understand where they are on the risk spectrum.
- In his view (and this was a more contentious point), there would be more competition if we actually had fewer players in the industry. What we need is to break the business model monopoly – but, perhaps, to consolidate the number of providers. AH.

“Whatever Lula wants...” The implications of the recent Presidential elections for Brazil (and its creditors). With Victor Bulmer-Thomas (Chatham House), Richard Lapper (*Financial Times*), Amalia Estenssoro (BBVA), David Lubin (HSBC), and Mahrukh Doctor (Centre for Brazilian Studies, Oxford). November 5, 2002.

Short-term, there was a (surprising) consensus that Lula’s victory is not the disaster that some had predicted – even if it is the biggest victory for the Latin American left since Allende. The expectation is that Lula will be broadly orthodox – and may even be able to avoid a “technical” default. Everyone accepted that Lula and the PT have genuinely changed, and that the elections do not in any way mean a new “axis of evil” in Latin America. The PT is serious about its commitment to fiscal targeting and macroeconomic austerity – which, indeed, was largely identical to the policies espoused by all the Presidential candidates in the final round. In that sense, Brazil has matured – and everyone wants to be optimistic.

But what about the longer term? That may be a different matter. There is a “structural and chronic dependency on capital flows” – and Lula’s Brazil faces growing global risk aversion. There is also the domestic debt problem. Once the honeymoon is over (and one or two speakers gave that no more than six months or so), things could turn nasty – precisely because the disappointment will be so intense. What will happen then? Inflation? Capital controls? It is going to be very hard for the PT to manage expectations, and it is going to be very hard for it to maintain a broader left alliance. One thing that would help would be a cyclical shift in favour of emerging market investment; there may not be too much Lula himself can do about that. AH.

Clued-up on financial inclusion. With Graham Halliday (Post Office), Marion Poole (Association of Friendly Societies), and Shaun Spiers (ABCUL). November 6, 2002.

This was a *tour d’horizon* of developments in the most sensitive end of the financial services industry. All three speakers are trying to tap those financial consumers who are routinely ignored by High St. banks, IFAs etc.. What themes came through?

- “Regulation is designed primarily for people in the middle classes” – who shout loudest.
- Unfortunately, the increasing regulatory burden is making it harder and harder to access the poorest – those who need most help with savings provision.
- Most initiatives aimed at those with limited resources (e.g. ISAs and stakeholder pensions) simply don’t do anything for the people they were intended to help. Indeed, some (e.g. the Savings Gateway) may actually undermine “natural relations” at the bottom of the market.

- There is a fear that financial inclusion has slipped down the government’s agenda – though there were signs that some private sector organisations are taking it more seriously.

What came through loud and clear is the need for more personal contact and for a relaxation of the crazier aspects of know-your-customer regulation. Plus, products aimed at lower income groups need to be “regulated for their simplicity”. AH.

The work of the EP’s Committee on Economic and Monetary Affairs - and its new group of advisers. With Ruben Lee (Oxford Finance Group), Fields Wicker-Miurin (Leaders Quest) and Philip Molyneux (University of Wales, Bangor). November 21, 2002.

We had all three UK members of this 10-member advisory group – and there was a lot of interest in what they were up to, not surprising given the importance of the Parliament and the amount of regulation remaining under the FSAP. The problem for the EP is, clearly, that it lacks financial expertise; plus, EMAC’s remit is just too broad (it covers everything from monetary policy to e-commerce). However, there was a feeling that, having had the sense to set up an advisory group, Christa Randzio-Plath (EMAC’s chairman) doesn’t really know what to do with it. Partly, there is a budget constraint; there have only been two plenary meetings. But there also seems to be a lack of vision. At the first meeting, members were allocated topics – Basel 2, clearing & settlement, the Prospectus Directive etc. They then went off and wrote briefing papers – a task which some appear to have taken a lot more seriously than others. Each got £3K, regardless of how much (or little) work went in, and there doesn’t seem to have been a great deal of feedback. Now, they all have new topics to cover – but, again, it’s a bit hit-and-miss, which is a pity because most of the group’s members seem willing to put a lot of time in and to consult with a wide range of interested parties. There was a clear sense that the more thoughtful EMAC members (? Chris Huhne) need to step in and make sure what the group has to offer is actually used. (Another thing to think about: at present, the group’s submissions are confidential. Does that make sense? Or would we all benefit if we knew what advice EMAC was getting?) AH.

The economic and financial consequences of Iraq. With Robert Mabro (Oxford Energy Institute), Dominic Simpson (Kroll), and Ala’a Al-Yousuf (Standard & Poor’s). November 27, 2002.

First issue: Will the US go to war (and if so, when)? No doubt from Simpson: “the war has started”. The UN inspection regime is beside the point. The Americans will be given a real justification, will create one or will go it alone. Same from Mabro – who also shared Simpson’s view that the initial military phase of the operation will go better (and faster) than most assume. The problems will come later.

Both agreed that Saddam Hussain has some nasty stuff – but only a very limited ability to “weaponise” it. The biggest threat may be short-range gas shells, which are as likely to hurt his own people as the enemy. Both also agreed that there is no major threat to Israel – and certainly not to Riyadh. Perhaps surprisingly, there was agreement (not shared all around the table) that the US will be able to keep Israel on the leash, and that the Israeli election is simply not an issue.

What about oil? Mabro was pretty sanguine: this is not a war for or about oil. But (given that the only deal the Iraqis have actually signed is with Lukoil) there will be some production concessions to be negotiated with the winners. (But don’t expect easy negotiations, even with the new regime.) As for the impact on price, Mabros’s best estimate (if Iraq does not hit Ras Tanoura) is that prices will fall. But there are uncertainties: will Iraq have mined its oilfields? If so, remember it took eight months to clear up Kuwait – so there could be short-term disruption. But, on balance, Mabro was pretty optimistic in the short-term. Longer-term, however, those who expect a sudden surge in Iraqi production may be disappointed: wells have been overworked, damaged and partially flooded, and any regime will be tough to negotiate with. The best that we can hope for is another 2-3 million b/d over 2-3 years.

The real surprise was probably S&P. Al-Yousuf took a different line to the other speakers: his base case is no war in the next six months. As far as regional ratings are concerned:

- Kuwait is clearly vulnerable, and the establishment is divided. But the government “can operate from a suite in the Dorchester” if it has to. From a financial point of view, war is therefore not a concern.
- Jordan is a bigger problem. Indeed, it already faces an internal threat from fundamentalists around Ma’an, and there is a lot to lose in terms of trade with Iraq and terrorism. There is also a question as to whether the White House could give Amman the aid it needs quickly. On the other hand, Jordan has very little external debt.
- Lebanon faces a public debt problem, and donor pledges aren’t coming through. The war also deters investors, and the outlook has to be negative.
- Turkey is undergoing a modest honeymoon – but there are many political banana skins. And, of course, the problem of IMF negotiations: Will there be the political will for structural reform?
- Egypt’s problems are not its external exposure. The big issue is the widespread poverty and anger, and the questionable ability of the government to maintain the pace of reform – but that is not new. AH.

“Capitalism without owners will fail: A policymaker’s guide to reform.” With Robert Monks and Allen Sykes. December 2, 2002.

This was a round-table on a paper that we published at the beginning of November, and it attracted a powerful audience

from the governance area. Not all agreed that the recommendations put forward were feasible, but there was general agreement that Monks & Sykes had put their fingers on the problem – the disenfranchisement of shareholders by management in the contemporary Anglo-American corporate. Agreement, too, on the “six inappropriate powers” that top managements have appropriated:

- the right to chose “independent” non-exec colleagues;
- *ditto* with “independent” auditors (really consultants);
- *ditto* again with remuneration consultants;
- the influence they have over pension fund trustees in favour of a network of non-activism on corporate governance issues;
- the patronage they hold over other fund managers who seek pension fund business; and
- the ability to block independent scrutiny of their M&A activities.

The abrogation of shareholder rights by collusion between managements and institutional investors is, to Monks and Sykes, a “systemic” fault that can only be corrected by external intervention – which means a pro-active stance by regulators. They demand:

- that auditing be split from any potentially compromising consulting work;
- that remuneration consultants have no relationship with management;
- that non-exec directors have independent investment banking advice;
- that pension fund trustees and other fiduciaries act solely in the long-term interest of their beneficiaries; and, most controversially,
- that shareholders should have the right (and obligation) to nominate at least three non-exec directors to each major quoted company.

These are radical proposals that would fundamentally change the way institutional investors view the firms they invest in. The authors don’t minimise this, and they offer suggestions for easing the transition via intermediaries who would take on some of the obligations. Not everyone at the round-table felt their ideas were realistic – but they are a legitimate attempt to circumvent the real problems that radical change would bring. AH.

“Who speaks for the City? Trade associations galore.” With David Lascelles, Mark Boleat and Richard Saunders (IMA). December 9, 2002.

This was a round-table on the recent report by Lascelles and Boleat, which we believe to be the first critical review of the TA landscape for some years. Lascelles began by explaining that the main conclusion of the report – that TA fragmentation in the financial services area is probably inevitable and not a bad thing either – was not what he was

expecting. Given that over 50 TAs purport to represent parts of the financial services sector, and that their budget is over £150m a year, he had expected a compelling case for rationalisation. But, instead, three main factors drive the move to fragmentation:

- the decline of institutions and the rise of products/markets (“not what you are but what you do”);
- the increasing granularity of regulation; and
- the disappearance of the old informal City.

Plus, there is the “Brussels factor”, which is forcing some TAs to seek allies elsewhere in Europe and which militates against a broad-based City institution.

Boleat agreed. The most effective TAs are the most focussed. Mergers tend not to work – but cooperation is mandatory, not least on Europe. He emphasised that a lot of this cooperation takes place outside the formal TA sector, through smaller dinners etc.

Kicking off the response, Saunders agreed that there is little push for a “super-TA” to face off against a “super-regulator”, and he pointed out that new TAs are springing up all the time. Maybe some of these outlive their usefulness, but, in general, the TA sector is now characterised by professionalism. This theme was picked up generally; the financial services sector is complex, and needs sophisticated representation, which it generally gets. However, a few points came up that are worth noting:

- There was a feeling that big institutions (which may belong to 15 or more TAs) often don’t handle multiple memberships well.
- Europe is a problem. Does each TA need an office in Brussels? Should some umbrella organisation provide a shared infrastructure there?
- It remains important but difficult to measure the benefit of TA membership. Everyone claims success, and everyone runs from failure. But it would be valuable to pin down the returns members get; work is going on in this area.
- Shrinkage of a sector doesn’t necessarily mean marginalisation of the TA. Indeed, for the building societies, the threat to their mutual franchise made their TA that much more important.
- There is an emerging international (or pan-European) TA structure on the retail side. But there is still no European representative body at the wholesale level.
- At present, with mergers and parts of the City in retreat, there is a danger that TA resources will shrink – at a time when continuing output of the FSA and complexity of the FSAP make the TAs’ role even more crucial as interpreters of what is going on and aggregators of industry opinion.

This is obviously an area that would support more work. We hope to get an “early harvest” of research that the Trade Associations Forum is doing (albeit, at present, with only limited involvement from the financial services sector). AH.

“A New General Approach to risk.” With Charles Taylor (Risk Management Association). December 10, 2002.

Taylor’s paper is a serious alternative to the painful process of Basel 2 – but is it too late? Almost everyone now accepts that Basel is unstoppable, even as they are more and more aware of the problems it brings (procyclicality, complexity, convergence on a single view of risk, excessive prescription etc). That is particularly true of the banks, who are now having to write big cheques to get their systems in shape. It is also true of the consultancies, who are licking their chops at the thought of the fees to come. But is it correct?

One of the lessons of this round-table is that most of the benefits of Basel have already been harvested, in that the dialogue with the Committee has forced banks to improve risk management procedures out of all recognition. Now come the costs – in terms of implementing a complex system, that is far from state-of-the-art and (Taylor’s contribution) seriously undermines bank governance. Financial analysis 101 says sunk costs should be ignored when evaluating a particular course of action – particularly when a cheaper and easier alternative is on the table.

Respondents to Taylor’s presentation didn’t fall over themselves to endorse his NGA – but no one shot it down. It is a neat way of thinking about risk that provides banks with the proper incentive to keep improving and that (unlike the original pre-commitment approach) is not susceptible to gaming. In lambda (the relationship between a pre-set loss threshold and capital threshold), it also gives regulators a powerful tool to tweak individual banks or classes of banks. Lambda also provides a new insight for analysts who will be able to compare institutions in-market and cross-market. Maybe the European Parliament should have a look at it in the context of CAD-3. AH.

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