

Financial *Innovation*

Newsletter from the Centre for the Study of Financial Innovation

Issue no 28

September 2003

From the director...

Just before the holidays, the Centre's Advisory Council met to plot the autumn work programme. The discussion covered several broad areas:

- City competitiveness: Among the issues that it was felt we should look at:

- whether it is worth trying to promote the case in Brussels that the UK's lead in financial services is now so great that this should be explicitly recognised (at least for wholesale markets), and that the "lowest common denominator" approach of the FSAP should therefore be abandoned in favour of simply adopting UK practice on a pan-European basis;
- the costs/benefits of flexible labour legislation in the UK (on balance, is a more or less hire-and-fire approach good for the City?);
- the different directions that regulation seems to be taking in the UK and in the US (where financial regulators seem to be competing for business); and
- what the new team at the top of the FSA might mean for regulation in the UK.

- Basel 2: Here, the priority has shifted. The two issues worth looking at now are what Brussels is up to with CAD3 and the (alleged) problems that US regulators face implementing Basel "on the ground".

- Pensions: The key is to go beyond (yet another) restatement of what is admittedly an enormous problem, and to look instead at potential solutions. We might try to publish an anthology of possibilities. (One interim step well worth investigating is whether the UK pension issue can be depoliticised, rather as establishment of the MPC depoliticised monetary policy.)

- Clearing and settlement: The pressing need here is a simple one - a succinct *tour d'horizon* of an impossibly complex landscape by someone who understands it well enough to sort out the wood from the trees.

- EU legislation: We must also get someone to walk us through the hills and dales of the FSAP - an issue on which cross-channel perceptions differ widely. Also, what (if any) implications does the proposed European Constitution have for the City?

- Housing: Obviously, a big issue going forward. Do we want to follow the US (or Continental European) model? Is securitisation of mortgage packages possible or desirable?

- Accounting: There was a lot of concern about the impact of fair value accounting, about FRS17 and about efforts to harmonise international accounting standards.

- Money laundering: Is it still the City's view that the demands being placed on it are disproportionate, inappropriate and (largely) futile? There have been several new initiatives that are worth looking at.

- Aid: Isn't it time that the World Bank-dominated, top-down, expert-heavy, fundamentally elitist (and palpably unsuccessful) approach to development assistance was rethought? Can one build a bottom-up model? (Should one even try?)

- Low inflation: There was general support for revisiting the impact that a prolonged period of low (or no) inflation will have on the financial services sector, on products offered, on profitability, etc.

AH.

Forthcoming Diary Dates Round Tables

September 15

EU forum on financial analysts : with Ian Mackintosh (Mackintosh Consulting).

September 16

The Lambert Review : with Richard Lambert (MPC).

September 22

Telephone banking : with Simon Walker (KPMG), and Tony Gandy (TPS Knowledge), Matthew Higgins (First Direct).

September 23

Branch banking : with Natasha Miller (Accenture), Peter Richards (BT), Phil Middleton (Ernst & Young).

September 29

Financial / investor education : with Diane Hay (Proshare), Anna Bradley (FSA), Craig Pickering (Money on-line Education) and Oonagh McDonald.

October 8

CP 185 : with Timothy Spangler (Berwin Leighton Paisner).

October 23

Effective dispute resolution : with Barry Mortimer (City Disputes Panel), Marie-Anne Bastin (Debacker Bastin) and Sir Philip Otton.

November 18

US implementation of Basel 2 : with Kevin Bailey (OCC).

December 4

Housing finance : with David Miles (HM Treasury/Imperial College).

December 11

London as a financial centre : with Paul Boateng MP, Michael Foot (FSA) and Sir David Walker (Morgan Stanley).

CSFI

Centre for the Study of
Financial Innovation

Publications

Only one report has been published since our last newsletter – but it was a bit of a blockbuster:

- *Sizing up the City: London's ranking as a financial centre* (June 2003): Written by my colleague David Lascelles (though a number of people contributed to what was one of the biggest pieces of work we have done), this was prepared for the City Corporation. It was based on 76 in-depth interviews with senior City figures and on 274 responses to a detailed questionnaire – all of which were designed to elicit how practitioners, regulators etc. in the UK and elsewhere *feel* about the competitiveness of the City of London, at the present time and looking forward. The intention was that a similar exercise could be conducted periodically, say once a year (either by the Centre or by someone else), so that time series data could be built up. It is worth emphasising that the report is about *perceptions*: there have been plenty of attempts to measure (say) the actual cost of real estate in London and its main competitors. What we were concerned with are the *perceptions* that drive business decisions.

What were the main results? The report highlights:

- the tremendous power of the London “brand” – everyone accepts that there is now no significant competition to London as a financial centre in Europe (the real competition is New York);
- the high regard in which the FSA is held as a regulator – notwithstanding real concerns about micro-regulation and about the drift of retail-type regulation into inter-professional wholesale markets;
- the tremendous advantage that “clustering” gives London when it comes to “subscription” markets (eg. Lloyd's, syndicated loans etc.), where co-operation is as important as competition; and
- the “distillation” of the highest value-added financial services in London, with middle and back-office operations likely to continue to be shifted to other cheaper centres.

All of this is broadly encouraging: London is miles ahead of everywhere except New York, and is likely to stay that way. However, there are a few clouds on the horizon – the appalling basic infrastructure, proposed changes to the tax regime, cost considerations, the FSA's penchant for micro-prudential regulation, and the perception that the government really doesn't understand (or support) the City. One dog that did not bark: the euro. The survey reinforced our long-held view that the City doesn't really care too much whether the UK is in or out of the euro.

Next to go is David's regular *Banking Banana Skins* survey, which is (once again) sponsored by PwC. As always, it reviews the main risks to the banking sector as viewed by practitioners, regulators and observers. And again, as always, the best predictor is probably to turn the top 30 upside down, since it is the risks that everyone thinks are under control that suddenly jump up and bite one.

AH.

Round-tables

Boom to bust? E-finance *does* work. With Conny Dorrestijn (Shiraz Partners), Michel Akkermans (Clear2Pay), Andrew Power (Deloitte) and Jeremy Larsson (Barclays). May 14, 2003.

This round-table stemmed from the CSFI's book on *The new world of European e-finance*, published at the end of 2002 (with help from Newsdesk Communications and Deloitte). Our premise was that a second wave of e-finance initiatives is underway – with Continental Europe well ahead of the UK this time round. Are we right?

There is certainly evidence of a “silent revolution”, and there is also evidence that e-finance take-up is indeed higher elsewhere in Europe. But why? One issue is internet penetration: 55% of Dutch homes now have access, compared with around 44% in the UK. Partly it is the more aggressive posture of Continental banks – Rabobank, for instance, now claims over one million internet clients. It may also have a lot to do with the range of services available: internet payments, for instance, are far more routine in, say, The Netherlands than in the UK. And, of course, there is the 3G debacle, and the low take-up of mobile payment systems in the UK. Plus the use of common platforms (ISOBEL in Belgium, for instance) – and there is a real danger that the Brits, who have long prided themselves on their technology lead in Europe, are falling behind.

FH/AH.

The Higgs report and corporate governance : A joint CSFI / ORFF discussion, with Derek Higgs, Digby Jones (CBI), Keith Grint (Saïd Business School, Oxford) and Annie Pye (University of Bath). May 15, 2003.



Derek Higgs

Held jointly with the Operational Risk Research Forum, this was a good opportunity to get behind the headlines of the Higgs report, to sort out those elements that are “must have” from those that are either too contentious (there are several of those) or those that Higgs himself would be willing to see dropped. There is no doubt that Higgs is a powerful proponent of better governance; equally, there is no doubt that he listens, and that he is not wedded to all the detailed recommendations of his report. Indeed, he seemed remarkably open on quite a lot of the detail. The aim is to bring clarity, to formalise procedures for utilising non-execs, and to create a better climate for decision-making at a board level; if some of the specific recommendations need watering down, he is willing to listen – even to Jones, who was not always as emollient as one might expect (though he insisted that UK industry is fully behind the general thrust of Higgs).

AH.

Current developments in the treatment of operational risk. With Charles Taylor (Risk Management Association) and Jonathan Howitt (Dresdner Kleinwort Wasserstein). May 20, 2003.

As Fed Governor Susan Bies has pointed out, operational risk today is where credit risk was ten years ago. Best practice is settling down, but (as this discussion made very clear) there is a long way to go – such a long way as, perhaps, to undermine the emphasis that the Basel Committee is placing on op risk management in its proposals. Nevertheless, progress is being made – and, from different perspectives, Taylor and Howitt are in the vanguard of moving operational risk from anecdote to discipline.

It is not easy, though. Line managers and traders are reluctant to change, and getting senior corporate “ownership” of better op risk control is difficult. There is also the issue of insurance: how can insurance be integrated into the operational risk framework? But the real issue is convincing people that better reporting pays off – in lower capital, in higher bonuses, whatever. And then, of course, working the data that is produced harder. Certainly, the statistical tools are improving, and there are some interesting data-sharing initiatives (BBA, Gold, the Operational Risk Exchange, the ABA etc), but there is still a long way to go before these can be properly used – and there is a consensus among op risk professionals that data exchange within the industry is still the key to better op risk management.

AH.

“Basel Lite” : recommendations for the European implementation of the new Basel Accord. With Alistair Milne (Cass Business School). May 21, 2003.

The Centre has long been sceptical about Basel 2 – too prescriptive, pro-cyclical, too complex, too expensive etc. But (like others) we have been short on alternatives. Milne, however, is not short of suggestions. Turning his attention to Brussels (which has to write Basel into EU legislation via a new Capital Adequacy Directive), he has identified three crucial problems with Basel 2 as it stands:

- it will be very hard to verify objectively, given dependence on internally-generated numbers, on a subjective probability of default, severity and loss;
- it will be excessively prescriptive and formulaic, downplaying the role of professional judgement; and
- it raises important issues of governance.

What he urges is that CAD3 should be drafted in such a way that as little as possible should be enshrined in the directive proper, with as much as possible of the detail consigned (effectively) to annexes that can be amended relatively easily under the so-called Lamfalussy process.

This split between “level 1” (principles) and “level 2” (practice) is crucial, Milne feels, if Basel 2 is not to become an uncompetitive straight-jacket for regulated banks. It gives flexibility where little or none exist otherwise.

To be fair, Milne may have underestimated the extent to which CAD3 as originally envisaged already incorporates some flexibility. But the general point is valid; if Basel 2 is to work, CAD3 has to be a very different kind of directive from what has traditionally been the norm in Brussels.

AH.

Assessing the ISD review : the recent CEPS task force report. With Mattias Levin (CEPS) and Adam Kinsley (London Stock Exchange). May 22, 2003.



Mattias Levin

The task force put together by CEPS to look at the Commission’s proposal for a new ISD focuses on two main aspects – fragmentation and the transparency regime. There is a lot more to the ISD (best execution requirements, for instance), but the CEPS paper still runs to almost one hundred pages. For CEPS (and for most

others), the key issues are whether the ISD increases contestability along the value chain (which it seems to), coupled with concerns about dispersion of liquidity and the central price-discovery mechanism. One concern is whether too much transparency might be harmful: there is widespread support for greater post-trade transparency, but pre-trade is a different matter. And that, as Levin found, is a big issue.

As drafted, the ISD approach is protective of active retail trading and central markets, and there is a fear that it will set in stone an approach that may not be appropriate everywhere. Since it is a “level 1” directive, changes will be difficult to make – which could be dangerous in such a contentious area. The CEPS report wants more in “level 2”. It also wants the focus to be shifted from pre-trade to post-trade transparency, and it wants more attention paid to better execution (though it is accepted that greater emphasis on pre-trade transparency may be a political price for progress elsewhere). There are lots of other issues in the directive – the definition of a market-maker, treatment of execution-only business, off exchange business etc. But pre-trade transparency is probably the biggest sticking point – and, unfortunately, it is another area where it is awfully hard to reconcile the UK way of doing things with the way they are handled on the Continent. Once again, it is “London vs Club Med”, and the general sense of this meeting was that it is really a toss up whether “this directive is better than no directive”.

AH.

Background: On April 7, the FSA published CP 176, proposing to make UK fund managers more accountable to investors. The FSA's proposals are in two related parts:

- fund managers would no longer be able to buy market pricing and information services, such as dealing screens, under soft commission arrangements; and
- the costs of acquiring other services in a package along with trade execution, such as research, could no longer be passed on by a fund manager to his customers without their prior agreement.

The FSA had asked for responses to its proposals by August 29, 2003 although this date has now been moved to October. As a result the CSFI held a meeting at the City Club on June 23 with broker dealers, fund managers, trustees, information providers and analysts. The FSA and BofE were also present, on a personal basis. What follows is a summary of the presentation (though this is not a reflection of anyone's particular position) and some of the highlights of the discussion that took place.

The FSA's perspective: The FSA appears to have four main concerns about the present system:

- opacity allows potential conflicts of interest;
- bundling and soft commissions potentially affect trading decisions adversely;
- bundling and soft commissions should be treated in the same way; and
- market discipline is weak in this area.

Accordingly, it seems to have four objectives:

- to improve transparency and accountability regarding commissions;
- to increase fund managers' incentives to control transaction costs;
- to push businesses towards better execution; and
- to reduce 'directed' trading and commission recapture.

The general feeling of the meeting was that pension funds and institutional investors look at overall performance, not specifically at transaction costs.

So is the FSA right to be so concerned? The consensus was that it is probably not.

Is there excessive dealing, for example? No one has produced evidence that churning occurs to support soft commission arrangements. Are inappropriate services being subsidised? The current regime of greater transparency has greatly eased this situation. Is the quality of execution impaired? This is impossible to measure accurately, but the general feeling was that this is not the case.

But what about the quantity of research produced – is there too much?

The meeting considered this question at length, and the suggestion was made that research can be broken down into three types:

- "groundbreaking" – i.e. high quality original thinking;
- general marketing – not truly research but part of the sell side's overall dealing product; and
- specialist and niche research, e.g. on small companies.

There was a feeling that a price could be put on groundbreaking and specialist research, but less so on general marketing. However, general marketing is an integral part of brokers' services, and although there appears to be too much produced (often of little or no value), there is no point in trying to separate its cost from total execution costs. To the extent that the provision of "marketing" research takes place for the benefit of the broker, rather than that of the fund manager, its provision becomes a cost of doing business. In a competitive market, rational fund managers would buy execution from lower cost providers who do not expend time or money on worthless services. The FSA's concern, however, appears to be that the bundling of all types of research into commission frustrates such rational behaviour.

At what level does the marginal analyst fail to add value?

The economics of the proposed European takeover directive. With Joseph McCahery (University of Tilburg and CEPS) and John Plender (*Financial Times*). June 5, 2003.

A round-table that makes one really wonder what the City stands to gain from the FSAP. The UK's approach to the single market in financial services is essentially defensive – trying to stop Brussels undermining what most practitioners feel is a perfectly good system. The proposed takeover directive is a good example of "lowest common denominator" legislation, where Britain's interest is little more than damage limitation. Unfair?

Maybe, but the directive has been in the works for well over a decade, and it is still miles from producing the level playing field for takeovers that proponents affect to want. McCahery's paper (co-authored for CEPS) makes this clear, even if he himself is much less sceptical about the worth of the whole exercise than was his audience. Maybe he's right: surely, the cause of an integrated pan-European capital market is worth fighting for. But the rows over breakthrough rules, dual class (or multi-class) stock structures, board neutrality etc etc etc seem endless, and the likely final result (as we have since seen) will please no one. Indeed, the failure of a Portuguese-brokered compromise leaves this draft directive as much up in the air as it has been for some years.

AH.

consultation, or Big Bang II?

*before he signed up, he was heavily involved in shaping the Centre's work on CP 176
is Preston put together some thoughts which we feel are well worth sharing.*

One participant suggested that seven analysts in any one stock should usually be sufficient. Instead, some have up to 38 analysts (AstraZeneca), and it is hard to see where they all add value.

A number of participants conceded that there is too much “me too” research, but there is no obvious way of reducing the number of firms producing such work – at least no solution from regulatory intervention.

In conclusion, there is a need to help clients understand true transaction costs; but it was felt that the FSA has not made a strong case for introducing legislation to achieve this.

What could the FSA do? There are a number of possibilities:

- do nothing;
- ban soft commission;
- enforce unbundling; and/or
- enforce total transparency.

The consensus was that the first or last options are most likely. There was agreement that payment by fund managers for investment research that is germane to the funds being managed is not an unreasonable use of end investors' money. Surprisingly, there was little evidence that higher quality independent research was bought with soft commission; indeed, hard cash is the normal means of payment. Nevertheless, issues remain about the volume of such research bought and about the price paid.

A strong plea was made for greater transparency to be tried first, whilst still allowing fund managers to buy research from the sell-side using client commission as the default payment mechanism.

What about the implications? Assuming the FSA proceeds with its proposals, the implications could be pretty serious.

There would be some acceptance of the extra cost by investors, and some commission rates might fall

– but there would be very little difference in the amount of research produced (because much is produced for marketing purposes and this activity will continue regardless) and the costs of research would not be recovered through wider spreads. However, there could be an increase in programme trading and crossing business.

On the buy side, fund managers would seek to recoup costs from investors and would try to negotiate commissions down. They would not consume less general research, but they might produce more in-house original and specialist work.

Would investors be able to resist higher investment management fees? They would certainly shop around and probably switch some of their business to indexed funds. However, it was not felt that there would be a dramatic switch to overseas asset managers.

As for brokers, they might see a reduction in their commission revenue – as well as further pressure to demonstrate the value of their research. It may be that there would be a move towards the explicit pricing of individual analysis. It was felt unlikely, however, that there would be any significant shift of business towards discount brokers, and there would be no change in dealing spreads as reference spreads are set competitively in exchange order books. To the extent that the cost of capital commitment were increased (i.e. effective spreads widened), trading volume might be expected to shift to some extent away from capital commitment towards “patient” order trading.

The CP 176 paper has clearly touched a raw nerve. It would appear that there are many questions to be answered about the amount of research produced and the fact that there does not appear to be effective competition. The consensus of the practitioners at the meeting, however, was that a solution of the type proposed by the FSA might not only be draconian, but could also be replete with unintended consequences.

The cusp of a revolution?: A discussion on the potential of off-shoring. With Chris Gentle and Andrew Parker (Deloitte Research). June 10, 2003.

This round-table was based on a recent Deloitte report which predicted that, over the next five years, the hundred largest global financial services firms will transfer up to US\$ 356 billion of their operations and two million jobs offshore – and which backed this fairly astonishing assertion up with some serious survey work.

Outsourcing, offshoring – call it what you will – has been around for years. But the Deloitte assumption is that it is

now “transformative”, and that pressure to cut costs will drive any functions that can be offshored to low-cost centres – India, China, Malaysia, Mexico, South Africa. Companies like Citigroup, GE and HSBC have shown it can work on a scale hitherto undreamed of, and the competitive advantage it has given them sends a message throughout the industry. As far as Deloitte is concerned, 30-40% of financial service functions can be offshored in a “first-wave” – but up to 70% can go longer term. Cost is, obviously, the main driver, but the depth of the labour pool, governance, and quality of life issues all pull in the same direction. The result is an inevitable rethinking of the basic banking business model – and a difficult internal debate over questions like the degree of control the parent should retain over offshored operations.

That, at least, is the theory. But it needs to be acknowledged that the speakers did not get it all their own way. Yes, it was agreed, there are huge potential cost savings. And offshore labour forces are increasingly sophisticated. But there are risks – political, infrastructural, legal. (The recent Mumbai bombing has emphasised this point.) Plus, training can be tricky, cost differentials (though still wide) are narrowing, and it is all too easy to overlook second order issues like patent protection. No-one said Gentle and Power were wrong, but there was a clear sense that the offshoring juggernaut is not absolutely irresistible.

AH.

The global FX industry: coping with consolidation. With Christopher Swann (*Financial Times*), and Mark Robson (Reuters). June 19, 2003.

This round-table was based on the report that came out of a CSFI survey conducted for Reuters in November last year on the future of FX and money markets. The general consensus from Swann's interviews and analysis was that after consolidation there will only be around ten main banks left in the industry, along with a very few niche players.

His major conclusions were:

- that volumes are important - but that, since most respondents thought that spot volumes would rise moderately at best, banks would need to look elsewhere for profitability (for example, derivatives);
- that as volumes increase (even modestly), so will volatility-making hedging much more likely;
- that there will be considerably more “white-labelling” – the few remaining large FX players will boost their volumes by providing outsourced services to smaller players; and
- that the pace of consolidation has increased significantly since 1998 – which means that the top ten players are already increasing their market share significantly.

Obviously, the issue of consolidation is the most pressing for the FX industry – banks will need to have large and sophisticated FX operations to have sufficient flows. The successful players will be able to provide services across a number of different platforms (such as the internet), whilst the small to mid-sized banks will need to create the illusion of their own capacity, presumably through outsourcing.

But what will be the impact for Reuters, which commissioned the report? (And for Bloomberg as well.) Consolidation may well mean a fall in sales of basic services, though this may be compensated for by providing a wider scope of service and perhaps by simplifying systems. There will always be strong institutional demand for research – the transparency of markets means the value added from research is noticeable – but whether this will be enough in the face of such consolidation remains to be seen.

FH.

CP 176 : A discussion on the future of bundled brokerage and soft commission. With Nic Stuchfield (The Stuchfield Consultancy). June 23, 2003.

CP 176 has got a lot of people excited – and some believe that, if implemented as the FSA currently proposes, it would mean the most radical shakeup of the City since 1986. Stuchfield is one of those – see his extended note in the box on pages 4 & 5. His presentation prompted a very lively discussion. Most of the points are reflected in his note, but a few are worth emphasizing:

- The key is performance, not commission. That is what concerns pension funds and other end investors.
- There probably is too much research around – much of it pretty worthless. But can one really draw a line between “good” research and marketing puffery? (And, even if one can, should one draw that kind of line?)
- How much time should the FSA really be spending protecting an informed end-user against himself?
- There was no real agreement on how much money is involved. Practitioners tended to be dismissive; regulators (naturally) much less so. Under the circumstances, that certainly argues for greater transparency.

What next? The intention was that this meeting should evolve into a CP 176 working group. The issue certainly warrants a closer look.

AH.

Management audit: What it is? Why do it? With Donald Brydon (AXA Investment Managers), John Viney (Zygos Partnership), David Kidd (Egon Zehnder), and Bill Acker (Acker Deboeck). June 30, 2003.

OK, I was sceptical. Management audit sounded like just another consultant scam to me. Billed as a psychology-based means of evaluating senior individuals and teams in a variety of contexts, it smelled a bit of snake oil. But maybe we cynics should bite our tongues. The topic attracted a strong audience – and Brydon (a powerful, no-nonsense City figure) proved a strong advocate. Of course, it can all sound very new-age: it is all about teams, culture and context, 360° evaluation and that sort of thing. But there is something there, and it has clearly been a valuable tool for new CEOs – and, indeed, in reducing the value destruction that seems to be a necessary corollary of most M&A activity. It may be significant that US market leaders (GE, Pepsico) are heavy users – though they tend to do it in-house. Of course, there is also the cattle prod of increasing regulation and escalating D&O insurance premiums. And Sarbox may give the management audit business a huge push forward, if only because boards will now be desperate to demonstrate responsibility.

AH.

The issue of trustee exemption and its potential impact on the City. With Stuart Bridge (Law Commission), Armal Cates (Clifford Chance), Hilary Lord (Linklaters) and Stephen Norton (Law Debenture Corporation). July 21, 2003.



Hilary Lord

This was a round-table that mattered – bringing an important issue to a wider audience, prompting serious press comment (three pieces in the *FT*), and forcing the responsible authorities to rethink their ideas. The issue is simple, but apparently esoteric. A proposed reform of English trust law would result in it becoming much more difficult (perhaps impossible) and expensive for professional trustees to limit their liability from negligence

suits. Fine, for the area of general trust law – where solicitors (and others) acting as trustees on behalf of widows, orphans etc. should not be able to escape the consequences of their professional incompetence. But a lot less fine in the financial markets, where trustees (in the eurobond markets, in structured finance deals and much more widely in capital market transactions) routinely restrict the demands that can be made of them.

This is important. These are enormous and fast-growing markets, where the UK has a global lead – often because of the flexibility of local law, particularly in the trust area. They are also highly mobile markets, which could pack up and move almost overnight, taking a lot of ancillary business (custody, settlement etc) with them. Lots of jobs are involved, and (for once) it is perfectly possible to make the case that realistic alternatives in Continental and Asian (even US) jurisdictions are available. Under the circumstances, there is a lot at stake – and we were grateful that Stuart Bridge (the law commissioner most directly responsible) was willing to come, listen, and effectively, promise not to do anything precipitous. Most of those at this well-attended meeting left convinced that a serious threat to the City had been headed off, but the issue remains one that must be watched carefully. It is part of the general problem that what makes sense for widows and orphans (or the retail investor or the consumer interest) can do serious inadvertent damage to inter-professional markets which have often grown up around little wrinkles in the law; iron them out at your peril.

AH.

Global credit derivatives: Risk management or risk? With Ian Linnell and Matthew Cottrell (Fitch Ratings). July 22, 2003.

This was a round-table on a recent Fitch report – and on the data that has come in since it was first published. Fitch probably has the best database on the credit derivatives market, and there was wide interest in what its survey has uncovered.

Given that 181 firms responded, coverage is obviously impressive – though Linnell and Cottrell conceded that their next push for better coverage must be with the hedge funds.

Main points:

- Since 1996, this market has gone from virtually zero to US\$2 trillion net – but it remains untested by the business cycle.
- There is some evidence that credit protection buyers may have an informational advantage – which leads to concerns about the concentration of risk among the sellers of protection. (There is already some evidence that one or two firms are pulling back from the market – notably Swiss Re.)
- Despite all the hoopla surrounding the market, it is still fairly small potatoes: 8% of total loans are covered at the maximum. One major inhibitor is the failure to develop satisfactory common definitions of what constitutes a credit event (ISDA is working on this).
- Perhaps surprisingly, the number of disputes that have arisen has been quite small – and mostly resolved bilaterally. However, CSFB and Nomura did go the court over Railtrack, and some legal track record is developing.
- What does this market mean for conventional export credit insurers – ECGD, Coface etc? Are they going to be squeezed out?
- The regulators are becoming increasingly interested in who is going to be left holding the bag – particularly if it is the retail investor. “Anecdotally”, this is what is going on.
- If one or two insurers/reinsurers are pulling back (as they appear to be doing,) are there new players who might come in? Is it an area that might/should be of interest to corporates, pension funds etc.? Could a new player price product better than the insurers did? Will Basel 2 bring new players in because they may not have to hold as much capital as the banks?

AH.

Who’s going to be left holding the baby? A dinner discussion on where risk is likely to end up in the financial system. July 23, 2003. (With support from Accenture.)

This was a new initiative – a completely open-ended discussion, with no kick-off speakers, on an issue that everyone deems to be important. In this case: in a world of securitization, of credit derivatives, of hedge funds, of trading, of financial engineering, where is the sediment of financial risk going to settle? Or, who is going to be holding the parcel when the music stops?

It was a small(ish) but pretty senior group, and we are grateful to Accenture for hosting the evening (which we hope to repeat). Chatham House rule, and all that; but a lot came out of the evening that is worth noting.

Running around the table (to find out the baggage that individual participants brought to the evening) elicited a litany of preliminary worries (some obvious, some not). In particular:

- “there is always some idiot writing (insurance) business he doesn’t understand”, perhaps via Bermuda, where (it was said) some companies may have to go on underwriting new business just to keep on paying;
- how will any insurer who has written any kind of guaranteed return product (and there are apparently lots more beyond the Equitable) survive in a low-inflation world?
- there is a whole new world of systemic risk around the idea of outsourcing; and
- as risk has moved off the balance sheets of financial intermediaries into the market, opacity has increased – making the regulators’ job that much more difficult.

As for the discussion itself, there was a lot of concern about the way Basel 2 (US\$100 million per bank just in implementation costs) and IAS would interact: “We are changing the world”. It was widely agreed (if deplored) that we are moving from a principles-based system to rules, and that, in the end, accounting standards will have to converge on the US model (with all its shortcomings). “Our tradition of truth and fairness will lose out” – despite the fact that the real need is for US GAAP to “go back to principles”. One consequence is that there will be “more volatility of reporting” – which prompted a spirited discussion of just what accounting is for. One cute suggestion: force companies to publish their bank statements every month, or make corporate tax returns public. (Why not?) Whatever, there was a consensus that conventional accounting only gives an accurate picture for two days of the year. As one participant put it, “we whittle it down to a single stupid number”. And don’t think that mark-to-market is an answer, since for most assets there really is no market. Risk is probabilistic – so what about publishing a distribution function?

As for credit derivatives, there was a clear sense that the German *landesbanks* are buyers of last resort – and also an assumption that *in extremis*, this means the risk will be “socialized”. But there was also concern about the reinsurers – almost all of whom have been massively downgraded since September 11, and some of whom are (allegedly) stalling on paying out on claims. Bank lines to insurers are growing: ought they to be a bigger concern?

A much broader concern was that the world itself is now changing so fast. As one participant put it, “you can have a one-in-300 year event every year if the world changes fast enough” – and that seems likely to be the case.

Other issues that got a chewing over round the table:

- the enormous growth in (UK) unsecured credit;
- the interaction of low inflation and the pensions problem;
- the massive inroads that the gambling industry (virtually unregulated, often tax-advantaged) could/should make into traditional financial business;
- the long-term impact of PFI contracts that are currently being entered into, virtually with impunity;
- the concentration of power in the global derivatives industry (where JPMorgan Chase is now more dominant than Drexel ever was in the heady days of the junk bond market); and
- the impact of the credit derivatives market on the original lender’s attitude to the borrower – does it make him “indifferent to failure”?

Lots to think about. And a model worth repeating.

AH.

Many thanks to Imago for coming on board as sponsors of the CSFI, and also to the Housing Finance Corporation, the Association of Corporate Treasurers, Abbey National, Morgan Stanley International, Deloitte Consulting, the London Stock Exchange, the Securities Institute, Euronext.liffe, Moody’s KMV, virt-x, BT, Prudential, Citigroup, the Bank of England, Aviva, the Law Debenture Trust Corporation and Deutsche Bank for renewing their support.

Centre for the Study of Financial Innovation
5 Derby Street, London W1J 7AB,
Tel: 020 7493 0173 Fax: 020 7493 0190
E-mail: info@csfi.org.uk Website: www.csfi.org.uk

Chairman of the Trustees	Minos Zombanakis
Chairman of the Governing Council	Sir Brian Pearse
Chairman of the Advisory Council	John Plender

Staff:	
Director	Andrew Hilton
Co-director	David Lascelles
Manager	Fleur Hansen
Assistant to the director	Rhiannon Davidge
Administrator	Alice Wilson

The Centre is a registered educational charity, incorporated under the Companies Act and limited by guarantee.
(Registered Charity Number 1017352)

© Centre for the Study of Financial Innovation, 2003