Financial *Innovation*

Newsletter from the Centre for the Study of Financial Innovation Issue no 29 January 2004

From the director...

This newsletter is (as almost always happens) far too long. Our last issue was published in September, and covered 13 round-tables. This one covers 24 – including our first-ever meeting (on *Banking Banana Skins*) in NY. Ideally, we should put out a newsletter every half-dozen round-tables or so; that way, casual readers may get a few pointers from what has been covered and not just a sort of historical record. We will do our best in 2004.

AH.

Publications

The curse of the corporate state: Saving capitalism from itself (January 2004), by Bob Monks. £25/US$40/€45.

Monks was the co-author (with Allen Sykes) of a powerful attack on Anglo-American corporate governance practices that we published in November 2002 . He is a leading corporate activist in the US, whose biography (by Hilary Rosenberg) is entitled "traitor to his class". He is also angry – angry that the progress he felt was being made in developing a more responsible business model has been put at risk by:

Bob Monks

- the way the US political process has been subverted (and suborned) by corporate America, such that the US is now effectively a "corporate state";
- the connivance in this of the press and TV – both of which are increasingly dependent on political ad revenues; and
- the virtual disappearance of the flesh-and-blood individual as a significant player in US politics in favour of corporate megabucks.

His latest paper (the angriest diatribe I have read in a long time) inveighs against many of the usual targets – shareholder passivity, the SEC etc. But it also makes a powerful case for the political disenfranchisement of the US corporation. If the US is to move back from "corpocracy" to democracy, the political legitimacy that corporations have acquired as a result of a series of (in Monks's view, disastrous) Supreme Court judgements must be removed. Politics is the province of the individual, not the corporation. Whether you agree or not (and not all will), it is powerful stuff.

Banana Skins 2003 (September 2003), by David Lascelles. £25/US$40/€45.

It is a bit old hat now (and, as noted, we have held a round-table on it in NY), but I realise that I didn't get to write anything about *Banana Skins 2003* in the last newsletter. (It was published in September, with support from PwC, and is available through Central Books, www.centralbooks.co.uk.)

As I am sure you know, this is a more or less annual survey of what financial services professionals see at the biggest risks facing their industry. The first such survey was carried out in June 1994, and this was the eighth. Almost all were (as this one) written by David Lascelles. What makes this year's survey more interesting than most is that we got a stronger response than usual – 231 respondents from institutions headquartered in 31 countries.

Forthcoming Diary Dates Round Tables

January 20
CSFI Advisory Council.

January 29
The Financial Markets Law Committee: A round-table discussion with Lord Browne-Wilkinson and Bill Tudor John.

February 10
The work of the Pension Committee: A round-table discussion with Adair Turner.

March 9
Hawala: A round-table discussion with John Wilson (IMF).

March 15
Financial technologies for LDCs: A round-table discussion with Peer Stein (International Finance Corporation).

March 16
The future of commercial courts.

Please be advised that all dates are preliminary until invitations are sent out.

CSFI
Centre for the Study of Financial Innovation

Many thanks to HSBC, PricewaterhouseCoopers, Aon, Lombard Street Reserach, Royal Bank of Scotland Group, JP Morgan Chase, City Consultants, Accenture, the Banking Code Standards Board and PA Consulting for renewing their support, to the Stuchfield Consultancy and Lloyds TSB for coming back on board, and to Richmond Events and Cityforum for their contributions.

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

Quite often, David and I differ on the lessons that should be drawn from the survey (he wins); but this year it is quite clear that the spectre of credit losses is what dominates bank concerns – not least because of the uncertainties about where risk really lies that have been stirred up by the debate over credit derivatives.

The other issue that we think merits special notice is the growing concern about regulation – particularly international regulation. This seems to be focused roughly equally on Basel 2 and on Brussels – where fears of what is in store are compounded by institutional opacity. If you haven't seen BBS 2003, you really should get your hands on a copy.

AH.

Round-tables

The European Commission's Forum Group on financial analysts. With Ian Mackintosh and Simon Jowers (European Commission). September 15, 2003.

Mackintosh was chairman of a 20-member EU group whose terms of reference were to provide the Commission with recommendations on best practice with regard to financial analysts – which recommendations were published at the beginning of September. Jowers provided secretariat services for the group.

There was considerable interest in what the group had to say, and in Mackintosh's elaboration of the dynamics within the group. On that score, he made it clear that the group was unanimous in its concern that the recent publicity over US analyst misconduct cannot be assumed to be unique – and equally unanimous that Europe needs to find its own approach to restoring and maintaining investor confidence. Beyond that, however, unanimity was thin on the ground – though that did not stop the group making significant recommendations. Mackintosh made a number of preliminary points about the group's general orientation. In particular, he said:

- the group supported general principles over specific rules and compulsive box-ticking;
- it conceded that integrated firms do pose a problem: while it understood that the bigger budgets that such firms have can make for higher quality research, there are real organisational issues that need to be addressed;
- the general feeling seemed to be that a "European" solution might be a bit less draconian when it comes to analyst involvement in origination and selling than the US approach – provided that controls are maintained;
- although the group did not come up with a specific recommendation in this area, it clearly felt that we need a better handle on how to monitor and evaluate analyst performance;
- just as there must be a code of practice for analysts, there must also be a code of practice for issuers – issuers must not be able to handpick their analysts;
- in general, the group felt, the buy-side is adequately covered by existing legislation – which means that we should concentrate on the sell-side, and specifically on wholesale sell-side research (though retail is undoubtedly a growth area for independent research); and
- the group was generally supportive of increased independent research – but it was acknowledged that the quality of such research is a pretty mixed bag.

In the end, the actual recommendations the group came up with were fairly bland:

- research should be fair, clear and not misleading;
- it should be produced with skill, care, diligence and integrity – and should reflect the opinion of the author;
- its distribution should take into account the different categories of recipient; and
- firms must have systems to identify, avoid, prevent or manage conflicts of interest – and, where they exist, such conflicts must be promptly disclosed.

Not much to disagree with here, but important nonetheless.

AH.

The Lambert review. With Richard Lambert. September 16, 2003.

Richard Lambert

This round-table was held just after release of Lambert's interim report on business–university collaboration in the UK – an initiative launched by the Treasury that resulted in an important final report in December. His terms of reference were to look at the benefits of interaction, to see how it works in practice, to investigate best practice at home and abroad, to see how business can make universities more responsive and to look at the effectiveness of government support.

It turned out to be an unexpectedly lively meeting – not least because Lambert (an ex-editor of the *FT*) was unexpectedly open. No dispute as to why this matters: when it comes to OECD research intensity, the UK is an outlier. Plus, investment in R&D helps move us up the international value chain etc. And no dispute either that UK universities have changed, and are still changing. But there are still lots of questions, raised by both Lambert and the audience:

- Is UK university research still too concentrated? Or are there in fact now too many centres of excellence?
- Does the much-maligned RAE process help or hinder UK research and business-university links?
- How can we reconcile the very different timescales of academic and business research?
- Is there too much emphasis at universities on spin-offs (which have a very mixed record) and not enough on the (less glamorous) cultivation of existing businesses and on licensing?

- Is the perceived sexiness of the biotech and pharmaceutical industries diverting resources away from more mundane, but perhaps more promising, areas (e.g. “the oil-free pump”)?
- Should we be uneasy about the incredibly important role that Rolls-Royce plays in the UK engineering area – characterised as “out of all proportion to its City reputation”?
- Should we perhaps devote more attention to R&D in the service sector, which tends to get short shrift when it comes to university research? (But note the stunning lack of interest from the City, as exemplified in the CSFI’s own report *Quant and Mammon*.)
- To what extent does the structure of research funding need to be rethought? Should there be a new funding stream based on mandatory collaboration with business?
- Could we give UK universities more autonomy – perhaps by adopting what one participant called a “risk-based regulatory structure”? (If so, would government really let a university fail?)
- What can be done to disentangle the increasingly convoluted problem of intellectual property? The consensus seemed to be that it doesn’t matter who owns the IP, so long as it is clear who owns it – and that is often very murky indeed.

Each of these questions (and more) provoked a robust debate, much of which was reflected in Lambert’s final report.

AH.

Retail banking: Rethinking telephone banking. With Simon Walker (KPMG), Tony Gandy (TPS Knowledge) and Matthew Higgins (first direct). September 22, 2003.

This wasn’t so much a round-table on phone banking as a discussion of non-branch banking channels – phone, internet or even mail. And it produced a number of insights (some based on painful experience):

- Non-branch banking is rotten for selling higher value-added products. Complex products need face-to-face selling. And, if you do manage to sell such a product outside a branch, chances are it won’t stay sold. As a result (even for first direct), there really is no alternative to a branch – even one with HSBC on the outside.
- Non-branch banking is essentially price-driven; it is perceived to sell commoditised products – and they are products that sell on price.
- That said, it is crucial to get distance banking right – and most offerings are still “crap”. The big exception (and there wasn’t much objection to this) is first direct, which is still felt to be streets ahead of most of its competitors on service levels.
- There is an important trend away from the telephone to other forms of remote access – notably the internet, which now dominates the business model of most established providers.
- Although everyone accepts the key continuing role of the branch, most of the banks’ investment spend is now going into non-branch channels. Only 30% of respondents to a recent survey said they intend to spend more on branches than on phone/internet services.

Looking forward, there was agreement that something has to be done about call centres. Somehow, they have to transmute into much broader contact centres – but, like it or not, it will remain very hard to sell high-value products through such contact centres, even in the broadband world which is nearly on us. One final thought: Basel 2 will make banks much keener to get their hands on retail money, and that will give a big boost to both branch and non-branch retail banking.

AH.

Retail banking: Rethinking branch banking. With Natasha Miller (Accenture), Peter Richards (BT) and Philip Middleton (Ernst & Young). September 23, 2003.

Philip Middleton

The lesson from this round-table (as from the companion meeting on telephone banking) is that branch banking is not dead – though it is probably being starved of resources relative to other channels. Many of the issues are ones that we have heard before – how to improve the “look and feel” of a branch, how to integrate other delivery channels with the branch, how to stream different kinds of customer (for instance, so that small businessmen are fast-tracked over OAPs, without upsetting either), how to use the information that branches throw up better, how to make branch staff more accountable and better motivated etc etc. But there are new wrinkles as well:

- There is growing recognition that other countries may actually be approaching branch banking in a more creative way than the UK – even such perennial retail banking know-nothings as Spain and Italy.
- Technology could give a big boost to branches. Until now, many of us have had more connectivity at home than the average bank branch; that will change. And the new technology will be smarter. A good example (which I think will prove far more significant than most yet appreciate) is the advent of cash deposit machines that will provide a physical copy of a deposited cheque and a certified count of cash.
- The banks are getting smarter about their own limitations. They have finally appreciated that they are not natural retailers – so they are buying retailers to run their branch networks. They are also learning the US lesson, that branches can become broader community centres – with both visible and invisible (social) payoffs.

Even so, there are probably still too many branches left in the UK, and some further rationalisation is probably inevitable. Could there be a resuscitation of the old (failed) idea of shared branches? Certainly, it was agreed that – in a world where customers are being driven to buy more and more complex

savings products – the future of the branch, as a focus for face-to-face selling, seems more secure than it did only a few years ago.

AH.

What can one expect of financial education? With Diane Hay (ProShare), Craig Pickering (Money On-Line Education), Oonagh McDonald, and Marie Calnan (FSA). September 29, 2003.

Being in favour of more financial education is pretty easy – until one starts to think about it. If it is in the schools, what should be dropped to make way for it? If it is in the workplace, who should pay for it? And, as tricky, who is sufficiently objective to provide advice that is not biased towards (say) equities, or that is not unduly influenced by recent history? And, of course, who is to say that greater access to financial education will actually help avoid mis-selling scandals; it seems to me that a little learning may be a very dangerous thing if it convinces Mr and Mrs Smith to punt the house on a derivatives contract.

Still, none of our speakers were willing to badmouth financial education as anything other than a thoroughly good thing – and it is quite clear that outfits like ProShare play a useful (if somewhat unambitious) role. There is clearly a need (growing) for practical, informal, face-to-face financial education, even if what one can expect from it should not be exaggerated. At the same time, there is an equally pressing need for financial products that are simple enough that people can understand them – but that is another round-table.

The FSA's role in all this is inevitably a bit controversial. In a more perfect world, financial education would probably not be in the FSA's remit at all – but, at the moment, there is really no-one else with the knowledge of the problem and an interest. Certainly, the industry itself (well meaning though it may be) cannot be expected to take on the role of educator – not least because it is inevitably *parti pris* and because there will always be product providers and salesmen who see merit in complexity and obfuscation. (Indeed, teaching consumers to be sceptical about product providers might be itself an important form of education.) Equally, a wee bit of scepticism is probably in order when it comes to consumer lobbies; *caveat emptor* is an important principle that must not be abandoned.

One problem with this debate is, of course, that we don't really know where we stand at present. Little jokes abound: "Half the population doesn't know what 50% means." But anecdotally, lower socio-economic groups are often very shrewd about money. It is not ignorance but poverty that makes them run up credit card debt. The kind of survey that ANZ did recently in Australia would make a lot of sense, particularly in the context of the Sandler debate. As the FSA is well aware, we need a much better picture of what is actually going on. (*Note: The Centre is trying to put together a sponsored dinner on whether it is possible to construct an easily-understandable visual measure of risk, that could be slapped on the side of retail financial products rather like an energy efficiency rating on white goods*.)

AH.

The Government's preparations for euro entry. With Hilary Thompson (HM Treasury). September 30, 2003.

Whatever one may think about the likelihood that Britain will adopt the euro any time soon, the government would clearly be derelict if it did not plan. The Treasury's Euro Preparations Unit, headed by Thompson, has been around since 1998 and has released six reports on euro preparations (a seventh was due in the autumn) as well as three changeover plans. The latest changeover plan, which was published in June, had a consumer focus.

Overall responsibility for taking forward UK preparations for membership of the euro, and ensuring that the economy is ready for changeover to the euro if a decision to join is taken, rests with a Standing Committee chaired by the Chancellor of the Exchequer. This Committee has senior Ministerial and cross-sectoral representatives from the Devolved Administrations, the DTI, the BoE, the BBA, the FSA, the BRC, the BCC, the CBI, the CA, the LGA, the RDAs, the NCVO and the TUC, and meets approximately twice a year. Thompson's EPU team, which co-ordinates the work of a number of other sectoral working and advisory groups, provides support to this Standing Committee. There is no doubt that the Treasury takes its responsibilities seriously – and, as usual, the UK's approach to EMU is a model for others.

What was particularly interesting is the timetable the Treasury is working to. Even if the actual dates are unknown, the sequencing seems pretty much locked in. Whenever the decision on euro entry is taken, there will have to be a minimum of four months before a referendum. After that, during the next 2½ years, rates will be locked, the retail transition will start and euro cash will be introduced (the Government's preferred date for this is April 6, the beginning of a new tax year). Two months after that, sterling will be withdrawn.

An enormous amount of work has clearly gone into a detailed "managed transition", drawing best practice from euro-area experience; but there is also realism. Thompson was frank about the importance of planning certainty before crucial investment decisions are taken. That clearly doesn't exist at the moment, but there was something comforting about the sheer competence of the Treasury's operation.

AH/HMT.

Credit insurance in Europe: With Amparo San José (CEPS) and Susan Ross (Aon). October 6, 2003.

The focus of this round-table was a CEPS report on European credit insurance, written by San José, a Spanish academic, that was published in February. The key message of this report (which was contentious, in that it arrived at rather different conclusions from some private surveys) was that the EU credit insurance market is extremely lumpy – well-developed in The Netherlands, Germany, France and Spain, but scarcely a factor in other

countries. Note that the UK not in the top group – a finding with which many of those around the table took some issue.

San José also complained about the lack of insurance products available to smaller firms in particular – an area where, according to her, the UK did particularly badly. Again, this was not a conclusion with which everyone around the table agreed, and it prompted a lively debate about how the market actually works in practice.

AH.

CP185: With Timothy Spangler (Berwin Leighton Paisner) and Julie Patterson (IMA). October 8, 2003.

Julie Patterson

Spangler's basic point is that CP185 provides a route through which UK institutional fund managers could make much greater use of hedge fund investments – as they already do in the US. His secondary point is that this potential has not been recognised – but that it could turn out to be very significant indeed, opening up a new world of investment opportunities to pension funds in particular (who are, he argues, way under-invested in "skills-based" funds). CP185 offers the possibility of hedge fund investments as a non-retail, professional product aimed at non-retail investors. There remain problems of tax status and FSA authorisation, but (according to Spangler) the FSA is working with the Inland Revenue and Treasury on tax issues to permit onshore hedge funds. (After all, France, Italy, Ireland and The Netherlands all have bigger on-shore hedge fund industries than the UK.) Assuming hedge fund legislation is liberalised (a big if), CP185 can make the sector boom as an asset class.

AH.

Effective Alternative Dispute Resolution: Recent developments in ADR. With Sir Philip Otton, Barry Mortimer QC (City Disputes Panel) and Marie-Anne Bastin (De Backer & Bastin). October 23, 2003.

This wasn't so much about ADR in general as about one particular type – mediation, in which Otton, Mortimer and Bastin are leading practitioners (Bastin in Brussels). It was also an opportunity to showcase the CDP as an underutilised City asset – more and more important as the UK's commercial court system becomes insanely expensive and positively third-world in terms of the facilities in which it has to operate.

The key advantages of mediation are cost and speed. The disadvantage, of course, is that (unlike arbitration) judgments are not necessarily final. There is also a rather sniffy view that it is inherently "amateur" – a nice little earner for retired judges, but not to be taken too seriously. Not so, insisted Otton and Mortimer in particular; it is becoming an increasingly rigorous discipline. And it works. In Ontario, one of several jurisdictions to have introduced mandatory mediation in the last few years (others include Australia, Florida and Texas), at least 60% of litigation is at least partially settled without going to court – which is a big saving in cost and in court time. Moreover, although Canadian litigation lawyers were initially unenthusiastic (as one would expect), it has now become part of the way of legal life. And it is coming to England: indeed, the Woolf reforms would require litigants at least to consider mediation.

A big question-mark (particularly in the City) is how in-house counsel will view mediation. The conventional view is no in-house lawyer has ever lost his job by calling in Messrs Linklater; but that view may not be right. Mediation can permit the client to control the process for longer than conventional litigation.
And, of course, there is the EU. The Commission already has a Green Book on ADR, and is now heading towards a directive. Given that mediation is better established on the Continent than in the UK, it is going to be hard to stop a Commission initiative – and maybe we shouldn't.

AH.

"*Banana Skins 2003*". Inaugural meeting of the New York CSFI. With David Lascelles. November 3, 2003.

Held at the Harvard Club, this was the first meeting of our NY affiliate. The intention of this initiative is to bring the same kind of robust round-table discussion to NY that we have developed over here – particularly in areas that are as relevant over there as over here. BBS is clearly one – and the discussion was just as lively as when Lascelles presented the same data in London (to several PwC audiences). Not surprisingly, governance was a big issue – as well as the conflicts of interest uncovered by Spitzer at Wall St. brokerages. The mutual fund scandal was only just developing, but the threat to "democratic" capitalism was a big concern.

AH.

The European Constitution and its impact on the City. With David Heathcoat-Amory MP, Chris Huhne MEP, Graham Bishop (grahambishop.com), and Bernard Connolly. (Hosted by Cass Business School.) November 11, 2003.

It is all Adam Ridley's fault … It was his idea that we should look at what Giscard's proposed Constitution would mean for the City (though why LIBA, the BBA, or the Corporation shouldn't have taken the task on themselves is not clear to me). Whatever, we thought we were offering a genuine public service by providing a platform for what we fondly assumed would be a finely balanced, essentially apolitical examination of the technical ins and outs of several hundred pages of legalese. And that's what *should* have happened (and *did* at the subsequent, much smaller working group meeting described below). But, in fact, this is an issue from which it is almost impossible to extract the political venom; for Connolly and Huhne in particular, the issues involved are just too important to lend themselves to dry technical analysis. As a result, while a lot of important points got put on the table (for

which much thanks to Heathcoat-Amory, who has summarised his time on the Convention in several articles of anguished detail), too much heat was generated and not enough light – leaving most of the audience little wiser as to whether the Constitution is the work of the devil (Connolly) or not much more than just a codification of agreements already entered into over the entire life of the EU itself (Huhne and Bishop).

This wasn't a discussion that lends itself to pithy summary. But a few points stand out, notably:

- There is a certain amount of "weasel-wording" in the Constitution: a "shared" competence, for instance, is not shared. It is one the Union has chosen not to exercise – and is, therefore, left for the member state.
- There was virtually unanimous agreement that – whether or not the Constitution is a fundamental change – the fact that it is so divisive means that there really must be a referendum to give it legitimacy.
- There was a fierce difference of opinion on what it would mean for Britain if it did reject the Constitution – particularly if the other big states accepted it.
- There was agreement that there is a dynamic towards harmonisation (regulatory, market, legal etc) that exists independent of the Constitution – and that it will continue whatever happens to the draft.

Other than that, look at the note on the subsequent working group meeting for more detail on the Constitution's impact on the City.

AH.

The gambling industry and wholesale finance. With Michael Mainelli (Z/Yen), Ashley Tatham (CityIndex), James Davies (Long Reach International), and Andrew Garrood (Cantor Index). November 12, 2003.

Michael Mainelli

The gambling industry (in which the UK is, sadly, a global leader) has the capacity to disintermediate traditional financial firms in several areas. Weather risk is one – though the market hasn't taken off – but the model is more general: wherever there are buyers and sellers of retail/ consumer risk, the betting industry can step in, often at a more attractive price than traditional intermediaries can offer.

This round-table did no more than scratch the surface, but it is clear that anyone who sees gambling solely in terms of conventional sports betting or casinos is missing a trick. House prices, television viewing figures, equity indices, relegation/ promotion insurance – the sky's the limit, and there can be significant tax advantages to go with the tight spreads (no stamp duty for one). Plus, the gambling industry doesn't carry all the baggage with which the global insurance industry is lumbered – nor does it have the cost structure of the investment banking industry. The FSA is already taking an interest; the industry is (broadly) regulated like execution-only brokers. But, even so, compliance costs are much lower.

What holds the industry back? That didn't come through so clearly. Certainly, spread betting is booming, and plenty of sophisticated City folk are well aware of what they can do with CFDs. But there is still a bridge to cross – a point acknowledged by Mainelli who has been involved with the packaging of weather risk since 1997, as well as with attempts to use betting shops to buy/sell the performance bonus coverage that soccer teams routinely buy (at a hefty price) in conventional markets. Maybe, for the moment, the pickings (notably in the online gambling market) are too easy; if that market were saturated (or turned down), a lot of talent could be released into direct competition with the insurers – giving them another headache that they really don't need.

AH.

A new look at National Savings (now known as National Savings & Investments). With Alan Cook (NS&I). November 13, 2003.

Alan Cook

Every couple of years (it seems) we look at National Savings – and every couple of years we decide (a) that running National Savings is one of the best jobs in Britain; (b) that the products it offers are great value (though, cynically, better value for the middle classes than for lower income groups); and (c) that National Savings's use of technology has been cutting edge. No big change this time – NS&I (as we must call it) is a tremendous, underexploited brand, with 30m customers (6-7m active), and selling around £1billion a month in a range of products from premium bonds to a guaranteed equity bond. In total, 12 products, all cash-based – which means, unfortunately, that the one market NS&I is not a player in is the market for retirement savings.

Of course, there are challenges. NS&I remains too dependent on the Post Office for distribution (there really isn't enough vigorish in it for NS&I products to interest the IFAs), but, in the new funding climate, there is clear government backing for NS&I to grow. Considering the difficulty industry has in offering Sandler-style products, NS&I must be well-placed – and it is hard to see why it should not start offering regular payment savings products that could take it into the retirement business. Unfair competition, some might say. But the fact is that National Savings offers a meat-and-potatoes product at meat-and-potatoes prices.

AH.

Doing Basel: Implementing Basel 2. With Kevin Bailey (OCC). November 18, 2003

Bailey – a deputy Comptroller at the OCC – attracted a strong audience, which was no surprise because (a) the OCC is the foremost US bank supervisor (as opposed to regulator); and (b) it

has made no secret of its concern that, as it stands, Basel 2 is going to be very hard to implement "on the ground" – both because it is so complex and because it will need a prodigious investment in manpower and training.

A number of points came out of this meeting that have not necessarily been made elsewhere. In particular there was some scepticism about just how much had actually been settled at the recent Committee meeting in Madrid – *inter alia* on the definition of expected losses, on securitisation, on credit risk mitigation, on the treatment of unused credit lines and on the timetable for Basel 2. Bailey flagged two big issues in particular:

- Credit card debt: As it stands, Basel 2 might require US banks to take a capital charge against unused credit lines on credit cards – a devastating blow that would force them to change their business model.
- The discriminatory treatment of specialist institutions: Potentially, there are enormous gains to be made, in terms of capital, for banks that qualify for the *A-IRB/AMA* approach – and that will give them a huge advantage *vis-à-vis* (for instance) smaller specialist mortgage lenders, despite the fact that the smaller lender may have an unimpeachable credit record. The differential in terms of capital may be crippling to smaller institutions.

Not surprisingly, US politicians are increasingly interested in Basel – and the result is that, whatever happens in Europe, the end–2006 deadline for implementation is far from certain to be met in the US. Indeed, Bailey warned, there will be a fourth QIS sometime in the middle of next year – and only after that is over (and any problems it reveals are resolved) can a Notice of Proposed Rulemaking be issued. And that is only the beginning of the process of writing new regulations. In the meantime, of course, the EU is going hell-for-leather with a Directive, based on the (heroic) assumption that CP3 will not be changed. Bailey did not spell it out – but others did: it is beginning to look as though there is a high probability that Euro-Basel will look very different from Basel-Americano. Roll on Basel 3.

AH.

The financial services industry in a low inflation world. With Roger Bootle (Capital Economics) and William MacDougall. November 19, 2003.

Roger Bootle

Bootle has recently published an important book, *Money for nothing*, which posits some real challenges ahead for the financial services sector, following the bubble of the last decade in technology stocks and house prices. In his opinion, the biggest challenge/threat – as big as the industrial revolution two hundred years ago – is the combination of China and India. In his view, they are not a bubble; they are the future, and their potential rate of growth is extraordinary. But, back home, the problems that a prolonged period of low inflation will bring are equally real – not least, because people have great difficulty ridding themselves of money illusion and all that it entails (the obsession with equities, the belief that house prices can only go up and up etc.). The danger is that, in a world of bubbles, we are all too busy taking in each other's laundry – not actually creating value.

In a low inflation world, Bootle emphasised, fund managers will have new responsibilities. They will have to understand what happens to annuity rates and to final salary pension schemes, and what happens if short term interest rates stay so low for a prolonged period. Other financial providers, too, will have to cope with lower margins, with greater transparency and with enormous competitive pressures. Of course, if we see actual deflation, things will be even more difficult – but that is not a real prospect, except perhaps in Germany. Nevertheless, low inflation will make things tough enough.

Of course, Bootle's world-view is not universally shared. MacDougall, for instance, made a plausible case that the real risk is higher inflation – not prolonged low inflation or deflation. And, if inflation does move to, say, 4%, bonds at 5% won't look such good value; Boots won't look so clever then. No real agreement on this – but there certainly was a consensus that we are at a very important inflection point, and that the financial services sector is going to be faced with big new challenges.

AH.

Regional equity markets: Recent developments. With Mary Martin (Advantage West Midlands) and Chris Prior-Willeard (PwC). November 26, 2003.

Mary Martin

The issues involved are basic: Is there an "equity gap" for smaller firms looking to raise (say) up to £250K? Is there geographic bias, which makes it harder for smaller firms outside the SE to raise money? Are there investors (also outside the SE) who would be willing to put money into firms they can see and touch if they didn't have to go through London or national markets? And, if so, can technology make regional equity markets work better than the old regional exchanges? Can it make the cost of raising money much cheaper?

Who knows? Which is why AWM's project (with technical assistance from PwC) to launch a 21st century virtual exchange in Birmingham is such an intriguing experiment. There were dissenters at this round-table, who felt that there was insufficient evidence of demand – and not enough support from the local brokerage community – to warrant the spending of government money, particularly when OFEX and AIM are trying to target much the same market. But the consensus around the table was that there are far worse ways to spend £5m, and that the information that this experiment will generate, whether it succeeds or not, will be very valuable.

But will it succeed? One key is clearly cost; can technology (and a certain amount of regulatory dispensation) really cut the cost of raising small amounts of money? Another is whether proponents are right in assuming that an untapped demand for local investments does exist at the regional level. And, of course, there is the exit issue: it is not just a question of buying small amounts of equity cheaply, but of being able to trade the equity easily in a liquid market. Can a deep enough secondary market be created?
Probably the least contentious area is the technology. Probably the most uncertain is the liquidity issue – though there are also legal issues that need to be settled before the mid-2004 scheduled launch (not least with Brussels Directives and EIS relief). But, on balance, the general advice seemed to be "suck it and see".

AH.

Anti-money laundering legislation: A good example of the law of unintended consequences? With Toby Graham (TaylorWessing), Mark Tantam (Deloitte & Touche) and David Maxwell (APCIMS). November 27, 2003.

The premise behind this round-table – widely shared in private, but not often said aloud – is that much AML legislation is misguided. It annoys Aunt Gladys, it makes it difficult (even impossible) for the government to achieve its goal of bringing the Del Boys of the grey economy into the (taxable) economic mainstream, and it jacks up the cost of financial services for everyone. Plus, as we all know in our hearts, it doesn't do much to catch either drug dealers or terrorists.

A number of other points came up during this important discussion that are worth noting:

- The various parties involved have different agendas – and they don't seem to talk amongst themselves. Plus there isn't much feedback, particularly from the police (see also the report on the round-table with NCIS). There is also an issue of whether you can have a true "partnership" when one party faces a criminal sanction if he gets it wrong.
- The cost of AML legislation is big – and asymmetric. The cost to the banks is well over £90m/year – whereas the police have spent (it is said) just £5m.
- There are tremendous tensions between, for instance, the work that the Better Regulation Taskforce is doing on KYC and those who have to enforce the Data Protection Act. Equally (it is said), the Assets Recovery Agency is sucking resources away from NCIS.
- Money-launderers are extremely good at making their transactions look just like all the others – which tends to undermine the assumption behind transaction monitoring, which is designed to pick up the anomalous transaction.
- There is a lot of talk that the AML regime is "risk-based". Unfortunately, the cost (for the banks) of getting it wrong is too high for a risk-based approach – so the result is a belt-and-braces approach in which thousands of SARs are submitted, the vast majority of which are known to be innocuous. Defensive behaviour is the norm. (One complaint in this area: the police don't seem to understand reputational risk.)
- POCA (the Proceeds of Crime Act) is, in some ways, bad law. Criminalising in the UK behaviour that may be lawful where it was carried out is dangerous – and risks running foul of human rights legislation. Every lawyer has examples of just what could, under a tight interpretation of POCA, be considered money laundering – and the examples are sufficiently bizarre as to risk bringing the Act into disrespect. There is also a big issue over what solicitors may tell their clients, and about "tipping off"; Dame Elizabeth Butler-Sloss has recently highlighted this problem, which is likely to become a big issue.
- There is a real possibility that what started ostensibly as AML legislation is becoming tax evasion legislation – in that true money-launderers will easily beat the system, while casual tax evaders (cash payments to nannies, VAT evasion etc.) will be caught. Maybe this is what we want, but it is disingenuous to call it AML.

Finally, the key point is that the financial services industry better wake up to what is going on. At the very least, it needs to be much more pro-active *vis-à-vis* the Treasury when it comes to revised AML guidance notes.

AH.

Putting behavioural economics into practice: With Charles Roxburgh (McKinsey & Co), Andrew Fleming (ABN Amro) and Daniel Read (London School of Economics). December 1, 2003.

Another very difficult topic to get a handle on. Behavioural *economics*? Or behavioural *finance*? And just how do you make a buck out of it either way? We all know the (growing) academic literature – Kahnemann *et al*. But how do you go beyond the well-understood discussion of biases, no matter how obviously relevant they are to the financial sector (overconfidence, anchoring, herding etc etc), to develop a business strategy, or better an investment strategy, that uses them to make money? Hence the considerable interest in what Fleming had to say, since he oversees a fund (launched in 1999) that is ostensibly managed on behavioural lines. But what does that *mean*?

Frankly, that wasn't so easy to work out – beyond a few general principles (reality isn't rational; 80% of turnover is speculative etc). But there are real truths in amongst the obvious: investment managers don't lose their jobs for buying Shell; portfolios tend to be overweight stocks that have recently figured in the news; managers (and investors) tend to attribute success unduly to skill, rather than luck; we spot patterns from very small data sets *if* these patterns fit our prejudices etc. ABN Amro's fund deliberately weights image (glamour attracts a premium), overreaction to recent events, under-reaction to basic longer-term information, and overconfidence. But how these factors come into play was not so clear, nor the interrelations among them. And, while the model seems to work pretty well, risk-adjusted returns are good rather than sensational – with a slice of the excess returns eaten up by high transaction costs. This led to a model revamp in 2002 designed to cut transaction costs, the results of which will take some time to become clear. All of that

humility aside, it is clear: (a) that there is something for investment managers to work with; (b) that there is wide intellectual interest in what is going on; and (c) that there is a growing market for behavioural funds, just as there is for other specialist funds.

AH.

Financial sector decision-making in Brussels. With Sir John Mogg. (Hosted by TaylorWessing). December 3, 2003.

Sir John Mogg

Mogg, now chairman of Ofgem, was D-G for the internal market and financial services in Brussels for 10 years until the beginning of 2003 – a period when D-G XV was still thought of as part of the British Empire. This was an opportunity to quiz him, in particular, on the FSAP – is it still worth it, given that (in City eyes) the UK seems to be fighting a never-ending battle to get the "least bad" outcome from a range of unpalatable alternatives?

Unequivocally yes (no surprise there). But the FSAP process is easily misunderstood. At the beginning, there was little real coherence – just a general desire to promote financial integration and to overhaul regulation. And there is no doubt that the 2005 deadline was too tight – even though some member states wanted to accelerate it. Prioritisation was also an issue. The Commission wanted clearer priorities, but member states were driven by politics – which made prioritisation difficult. Even now, it is easy to underestimate the difficulties:

- It is hard to keep all member states and the Parliament on board.
- Without the Lamfalussy process, progress would be difficult (if not impossible) – but the process itself remains politically controversial, because it affects the EU's inter-institutional balance.
- Consultation with industry (and regulators) is not easy – though (*vide* the ISD) it seems to be getting better.
- The reluctance of member states to prioritise leads inevitably to bunching – which can force the Commission to step in with its own ideas.

As far as the City is concerned, it has been slow to appreciate the FSAP's importance – and slow to appreciate that it is crucial to make its views felt early on in the process, particularly when drafters may not be fully familiar with the context of the rules they are drafting.

What of the FSAP's benefits? It will take 5-10 years, but there will be "big prizes" even if no country ends up getting exactly what it wants. (It is worth remembering that, whatever the City feels, many Continental countries feel the FSAP is a UK plot.) And, even now, markets are freer – sometimes to the chagrin of other D-Gs, where the top priority may be a narrow definition of consumer protection (rather than, say, market efficiency).

As for the future, clearing & settlement must be high on the Commission's list. Cooperation with the US is also important, not least on the IAS debate. And, of course, Lamfalussy must be made to work. For the UK, the City must engage more fully – and earlier in the process – if it wants its view to prevail. Current rows over the ISD (or the Market Abuse and Prospectus Directives) could have been headed off with earlier intervention. (Article 25 of the ISD is a particular bone of contention.)

In response, there seemed wide acceptance that the UK and City have not made the best case for London as the EU's "jewel in the Crown", and some participants were less kind than Mogg about the Treasury's role over the years. There was agreement that City voices are fragmented, and that this diminishes the UK's influence. But, even so, some wondered whether the UK might not have accepted too many compromises right across the FSAP; after all, the City spoke with one voice on Article 25 – and still didn't get what it wanted. This was contentious. After all (as some others pointed out), the situation might have been a lot worse without the FSAP. But there was wide agreement that (at the least) other member states view the "market" with a lot more suspicion that the UK – which means we will always have to fight smart in Brussels.

An excellent round-table, which gave us a fascinating insight into how decisions are *really* made in Brussels. It would be a tragedy if Mogg's unparalleled knowledge of the Commission is lost to the City; he needs to be pumped dry before Ofgem's problems overwhelm him.

AH.

The European Constitution and the City: A working group meeting. December 4, 2003.

This was an attempt to defang the politically-loaded debate about the Constitution, and to concentrate instead on the boring technical detail. It benefited from a smaller group of participants, a less overtly political atmosphere (although there were politicians) and a level-headed outline provided by Geoffrey Fitchew (ex-DGXV). The end result (though, it must be stressed, not everyone at the meeting would have agreed with everything in it) was an *FT* op-ed piece by David Lascelles and myself.

The main point of this piece was to urge politicians (about to meet at the Brussels Summit) not to be seduced by headline issues of governance into ignoring the less exciting details of the Constitution – which, if not addressed, could inadvertently create a less hospitable environment for European financial markets (not just the City). The group worried, in particular, about:

- the Constitution's formal endorsement of the "social market" model, the emphasis on labour market regulation, the enforceability of the Charter of Fundamental Rights – and the cumulative effect that they might have on European competitiveness in a global economy;
- the possibility that under proposals for the ECB, key aspects of financial regulation might be moved from national regulators to Frankfurt by QMV;

- the possibility (disputed, but real) that, in time of crisis, control over energy policy and energy resources could be taken out of national hands;
- the possibility (also perhaps more a matter of sloppy drafting than of intent, but who knows?) that, by proscribing the use of expert groups, the Constitution could undermine the so-called Lamfalussy process, on which the FSAP increasingly depends;
- the unfortunate and ambiguous drafting (in English anyway) of the provisions concerning data protection – which appear to impose a single EU DP "czar" and to make DP subject to a European "law" (not a "framework law");
- the transfer of certain budgetary decisions to QMV – meaning (at the risk of British parochialism) that the UK's budget debate could be in jeopardy; and
- the assymetrical treatment within the Constitution of "subsidiarity" and "proportionality" – national parliaments will be able to challenge the Commission if it ignores subsidiarity, but they will have no right to challenge breaches of proportionality.

In the event, the Brussels Summit failed to reach agreement, and the Constitution has been shelved – though for how long it is impossible to say. What is clearly important (for both opponents and supporters) is that the next few months are not wasted; the City needs to go through the draft Constitution line-by-line, and it needs to make its concerns (if indeed there are any) known well before the next Summit.

AH.

"Spitzer risk": the mutual fund investigation in the US, and its wider implications. With Roger Kubarych (HVB) and Dick Saunders (IMA). December 4, 2003.

Very topical – and, not surprisingly, well attended. There is real outrage in the US (shared by Kubarych) that the squeaky-clean image of the mutual fund industry should have been besmirched in this way – and concern about the knock-on effect on savings more generally. According to Kubarych, up to 25% of US mutual funds may have been involved in (illegal) late-trading or (less clearly illegal, but certainly unethical) market-timing. (Interesting that there was no consensus around the table on a precise definition of market-timing.) Lots of issues came up:

- How long has it been going on? Kubarych noted that SEC staff produced a paper on market timing abuses in 1997.
- Spitzer's motivation – Kubarych is a big supporter.
- Isn't it time for a radical rethink of US corporate governance? We need to do for governance what FIRREA did for the US S&L industry in 1989 – toughen up the rules.
- Equally, isn't it time to change the SEC's mandate – strip mutual fund regulation out, and give it to a specialist agency (on the OCC model)?
- At the least, this has to be the excuse to do something about soft-dollar commissions, bundling etc.

Kubarych's suggestions: Ban companies that breach their fiduciary obligations from starting new funds for a year? Ban big investors from mutual funds altogether (they are after all, a retail investment vehicle)? Use the triple damages provisions of US securities law to hit broker-dealers so hard they will never even *think* about abusing the rules again? Make more use of the investor trustee concept and drop the charade of mutual fund board responsibility? Add an idea from Paul Volcker: if you don't like market-timing, ban round-tripping.

But just how relevant is this to the UK? No surprise that Saunders was a bit sceptical. UK rules on late-trading and market timing are way ahead of the US, and the role of depositories and trustees make abuse much harder. Not impossible, but tougher – a view that was generally endorsed around the table. (see also the box on p12).

AH.

NCIS and the financial services industry: With Kathy Woodfine and Dave Copley. December 10, 2003.

The National Criminal Intelligence Service is the brains of the UK's police forces; it is also the recipient of the hundred thousand (or more) Suspicious Activity Reports submitted each year by banks, brokers, and, very soon, lawyers and accountants every time a faintly anomalous transaction or request comes across their desks. Woodfine and Copley work for NCIS's financial intelligence division – Woodfine as one of a handful of cops with some City experience (BofE) and Copley (a 20-year police veteran) in charge of City liaison.

Both were willing to talk about NCIS's role – but it was clear there is a gap between cop-think and City speak, and a marked asymmetry of aims. But NCIS is important – and FID extremely so. Both Woodfine and Copley acknowledged the resource constraint; FID has a handful of staff to process the SARs, which makes filtering a priority. And both acknowledged that the SAR backlog had been horrendous – prompting a thoroughgoing (and well received) review by KPMG. Things are much better now – thanks to KPMG and thanks to a task force that was to report by end-year. There is now a risk-based approach to processing SARs – and there is every hope of making the SARs themselves easier to fill in, while eliminating the least significant. (Fat chance, said some; the regulatory pressure that financial institutions find themselves under, and the cost of getting it wrong, will ensure that everyone will cover his ass – and if that means swamping NCIS with details of Granny Bloggs's fancy-man's account, *tant pis.*)

NCIS is also trying to be more user-friendly: a website, a newsletter. It is not much (yet); but it is clear that both speakers appreciate the need to get the banks on side – to convince them (and everyone else who has to submit the dreaded SARs) that the information isn't wasted, that it actually does help bring bad guys to book. The key word is feedback: NCIS promises it, and the City wants it. But it is going to be a long haul. Although Woodfine is clearly City-literate, there is a very obvious gap between the way the City thinks (and the language it speaks) and the way the police think (and speak). There needs to be a lot more cross-fertilisation (secondees both ways).

AH.

"Sizing up the City – London's ranking as a financial centre": A discussion on the CSFI report, with David Lascelles, Michael Foot (FSA), James Sassoon (HM Treasury), Sir David Walker (Morgan Stanley), and Duncan McKenzie (IFSL). (Hosted by JP Morgan.) December 11, 2003.

David Lascelles

This gave Lascelles the opportunity to present the report (prepared for the Corporation of London) that the Centre had published in June – and for regulators, practitioners and City promoters to respond.

First, a disclaimer: the report was based on a survey. It, therefore, reflected the views of those surveyed. And respondents were asked for their *perceptions* – which means that it is a survey of perceptions, which may (or may not) accord with "reality". Second, it was a survey of perceptions at a particular point in time. From the Corporation's point of view (*ditto* the FSA, Treasury and Bank), it would make sense for a similar study (albeit with one or two refinements, such as a clearer distinction between wholesale and retail markets) to be carried out periodically, so that time series data can be built up – a point that seemed to be generally accepted. (The CSFI is not fishing for this work, though we would not turn it down if it were offered.)

Lascelles emphasised several messages he drew from responses:

- despite City concerns, on balance FSA regulation is a big plus for the UK;
- the City has a tremendous talent pool;
- unfortunately, this government is still widely perceived to like a bit of City-bashing;
- the UK is not felt to handle Brussels well; and
- there is a feeling (surprisingly widespread) that the City needs a "champion".

The respondents picked up on a number of points. In particular:

- The report probably doesn't draw a clear enough distinction between retail and wholesale finance; the issues are very different. (Accepted.)
- There may be no "champion" as such, but the FSA is increasingly innovative (e.g. on Islamic finance) and the Treasury is getting more involved – particularly on issues like the proportionality of regulation.
- The report is right to stress the footloose nature of wholesale finance; after all, the City's own success was built on the unintended consequence of US domestic legislation. And, only a few years ago, the entire Lloyd's market came close to extinction. It can happen.
- The term "City" is probably misleading. After all, the hedge fund industry (the UK's fastest-growing financial sub-sector) is almost entirely non-City based.
- We all need to pay more attention to financial infrastructure issues – control of clearing and settlement is moving further away from London.
- Even if there is no pressing need for trade association rationalisation, there is certainly a need for closer collaboration – and for stronger industry representation in Brussels (and, arguably, in Canary Wharf as the FSA develops its regulatory proposals).
- Generally, wholesale finance is becoming "location independent" – a new phenomenon that will pose entirely new challenges to a centre like London.
- There are new challenges coming from Brussels of which the City must be aware. For instance, although a single legislator may have been "kicked into touch" (for now), there is growing pressure for a single rulebook – which could be almost as onerous.

It is worth noting some of the IFSL statistics presented by McKenzie. For instance, London ranks No.1 in global markets from base metals to shipbroking to OTC derivatives to FX trading; there is simply no competition (at the moment). It even leads Germany 2:1 in Eurex turnover. Moreover, financial services contribute over one million jobs to the UK, 5% of GDP (that seems too low) and a trade surplus of £17billion – a patrimony not to be squandered.

AH.

The UK mortgage market: Taking a longer-term view". With Prof. David Miles (Imperial College). December 18, 2003.

Professor David Miles

As befits a former chief economist at Merrill Lynch, Miles is a bit smoother than the average UK academic – but his interim report on UK housing finance is a powerful intellectual piece of work, and not (as some cynics had suggested it might be) a bit of New Labour special pleading. This (well-attended) round-table was duly impressed.

The issue is simply why does the UK housing market have so little long-term fixed rate lending? And, if there are any obvious obstacles to the development of such a market (which exists widely in the US and Continental Europe), can they be removed? Miles was adamant that there is no (explicit or implicit) assumption that fixed is better than variable – merely that, if there are market imperfections that stop a long-term fixed-rate product from being developed, we should see whether they can be eliminated.

Among the points raised, several stand out:

- rightly or wrongly, those who take out mortgages in the UK are overwhelmingly (some would say inordinately) swayed by the initial interest rate on offer – a rate which is often the product of cross subsidy (ie is paid for by variable-rate borrowers);

- low nominal interest rates mean that small changes in rates can (given the UK's well-known sensitivity to short-term interest rates) have a sudden and disproportionate impact on mortgage affordability;
- there is a surprisingly (at least to an economist) low value placed on the predictability of mortgage payments that a fixed interest rate could provide (though it was also pointed out that, even with a variable rate, payments could be kept level if the term of the loan were elastic); and
- there has to be concern about the increasing ratio of loans to income, particularly for first-time home buyers (in London and the SE, 60% of first time buyers now take out a loan that is more than three times their income, compared with 13% 10 years ago).

However, even if one accepts that it would make more sense for more people to take out long-term fixed mortgages (and it is worth noting that many people at the round-table disputed that, arguing that floating rates have been rational at least over the last twenty years), there are difficult funding issues that need to be addressed. No secret as to where Miles's thinking is going; his final report will be an important read.

AH.

Shortly after the round-table on Spitzer risk (p10), Roger Kubarych circulated to participants a note he had written on where the US mutual funds scandal is going. The most important part of this was the last: "What can be done to prevent further abuses". The following is a (slightly) edited version of Kubarych's conclusions:

"It has become a cliché for industry apologists to say that you can't legislate morality. But you can put in place mechanisms to detect law breaking or behaviour proscribed by a fund's own prospectus and take steps to end it. Some or all of the following suggestions are worth consideration:

1. Compel all mutual funds to introduce stiff redemption fees, rather than merely allowing larger fees to be applied.
2. Bar round-tripping altogether by banning in and out trades within a day or a week.
3. Bar large investments in mutual funds. If a fund complex wished to set up a separate "clone" fund for institutional investors, that should be possible. But investments above, say, $1million have no place in a fund meant for the little guy.
4. Get rid of the 4pm fixing and mandate fair market value pricing on a continuous basis. (The problem is that this is a proposal which can't be implemented for most securities, for which market prices are not available outside normal trading hours.)
5. Support the SEC's hard 4pm time limit for transactions, even for the bundling or 401k type actions which at present are allowed to be effected after 4pm if the retirement plan participant had initiated the request for the transaction before 4pm. (The difficulty is that the back-office problems would be formidable and it is genuinely unfair to people on the West Coast, for whom 4pm is 1pm.)
6. Legislate a tax-free window that would allow shareholders of abusive mutual funds to close out accounts without triggering a taxable event.
7. Beef up the SEC's examiners for investment companies. There are well over 10,000 bank examiners in the US to oversee the banking system. The mutual fund industry has just about the same amount of assets, but there are something like 350 examiners to do the same kind of work. That is not enough.
8. 80% of mutual fund are sold through brokers. Make the brokers liable for triple damages for selling any mutual funds that they know are involved in corrupt practices.
9. Bar mutual fund companies that permit market timing from launching any new funds.

"All of these are interesting. But for there to be fundamental change, the corporate governance of mutual funds has to be radically redesigned. Here are some suggestions:

1. Eliminate mutual fund boards. The fund management companies will then be the sole entity with which the individual shareholder must contend. To make sure the shareholder is not abused, there would be two alternatives. Either the fund company would put funds under the supervision of a Master Trustee. Or the fund could pay a fee and ask the SEC to perform that function.
2. Retain mutual fund boards, but put teeth in them by giving them real responsibility. That would require limiting the number of boards a director could serve on, much in the same spirit as FIRREA does for depository institutions, and/or making independent directors personally liable to shareholders for gross negligence by the fund manager.
3. Force independent directors of mutual funds to write an explanatory letter to all shareholders for funds that underperform their benchmarks by more than a specific percentage for three successive years.

"This does not exhaust possible remedies. But retail shareholders have a right to have their interests protected. The SEC should take the lead in making sure they are. But if the SEC doesn't do it, I suspect that the only alternative will be to let in the trial lawyers. That surely will be the outcome if the housecleaning is not done quickly and well."

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
Director of studies	Fleur Hansen
Assistant to the director	Rhiannon Davidge
Administrator	Simon Basey
Administrative assistant	Louise Banham

The Centre is a registered educational charity, incorporated under the Companies Act and limited by guarantee.

© Centre for the Study of Financial Innovation, 2004