

Financial *Innovation*

Newsletter from the Centre for the Study of Financial Innovation

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From the director...

Our last Advisory Council meeting (held in late January, under the chairmanship of John Plender) gave us plenty to chew on. The main issue-areas we covered were:

- **Pensions/retail savings:** The key questions are FRS17, housing as a form of savings, and the fairness issue. Could it be that public sector workers are now *overpaid* – but that they don't realise it since their benefits are backloaded?
- **Corporate governance:** Here, key questions include whether it is possible (or desirable) to cap auditor liability, the extent to which European legislation is now being driven by Sarbanes-Oxley, the global implications of auditor concentration, the receding prospect of GAAP/IAS reconciliation and the governance issue as it applies to non-listed companies.
- **Europe:** There is still work to do publicising the Constitution (bound to be resurrected this year), but there are also several directives that need a good going-over – the Takeover Directive, the Audit Directive, the third Money-laundering Directive, CAD3 etc etc. All in all, has the FSAP been worth it, from the City's point of view? And does the City need a "champion" to help it "box clever" in Brussels?
- **AML:** Two views – is it a legitimate response to criminal/terrorist threats, or is it the "financial equivalent of speed cameras" (a way for regulators to raise money)? Is it largely a waste of time, or do recent improvements in technology mean that the information that is collected can finally be used to track and stop bad guys? And how exactly is money laundered in the real world?
- **Exchanges and infrastructure:** The most important issue is probably the all-in cost of trading. The economics of consolidation is also an issue worth looking at.
- **Insurance:** PI and D&O insurance are a big issue. As discussed below, there are also more fundamental questions about the insurance model and the products that it offers to the markets.
- **Technology:** Probably worth looking at who survived the bursting of the internet bubble – and why.
- **Risk:** This is an interesting area. One paradigm worth examining is that of the "High-reliability Organisation". Are banks HROs? (And, if not, should they be?) Are payment systems? A buzz-word is Enterprise Risk Management (or ERM): is it worth bringing US practitioners over here?

Lots to be looking at over the next few months.

Round-tables

The Financial Markets Law Committee. With Lord Browne-Wilkinson and Bill Tudor John. January 29, 2004.

This was a meeting to discover what has happened since the Financial Law Panel was disbanded. Judging by the audience, we were not alone in our curiosity – which raises the question of why the FLP was dumped in the first place. The answer seems to lie in the FLP's initial rationale: it grew out of the Hammersmith & Fulham affair, and the need for clarity in legal obligations. By 2001, the panel had (it was felt) become too distant from the main preoccupations of practitioners – but the need still existed for a body to ensure a "sound legal environment" in the City. Hence the BofE stepped in, and the (broadly independent) FMLC was created.

Forthcoming Diary Dates Round Tables

March 24, 2004

How much is a UK university education really worth? A round-table discussion with Sir David Davies (EFG Private Bank), Nicholas Ulanov (Ulanov Partnership) and David Palfreyman (New College, Oxford).

March 24, 2004

International accounting standards: A round-table discussion with Professor Geoffrey Whittington (IASB).

April 1, 2004

Financial capability: A round-table discussion with Ron Sandler (pfeg).

April 7, 2004

Pension problem solutions part I: A round-table discussion with Christine Farnish (NAPF) and David Willetts MP.

April 19, 2004

REITs: A round-table discussion with Nick Catton (HM Treasury) and Ross Fraser (Herbert Smith).

April 20, 2004

Pension problem solutions part II: A round-table discussion with Peter Lilley MP.

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

CSFI
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AH.

Many thanks to the Halifax, the Finance & Leasing Association, Accenture, the DTI, Standard & Poor's, Barclays, Chown Dewhurst, the FSA and Link Interchange Network for renewing their support, to Aberdeen Asset Management and the International Primary Market Association for coming on board, and to Bob Monks for his contribution. The New York CSFI has also received contributions from Clifford Chance and the Starr Foundation, for which we are very grateful.

It is not a “lawyers’ lobby”; indeed, by no means all its members are practicing lawyers. But it brings together senior members of City law firms, regulators and officials, with an agenda (amongst other things) to identify the “hidden hazards” that the City faces. It is practitioner-driven, and it aims to sort out problems before they do damage. The Committee acts as a bridge between the City and the judiciary – not a bad thing, given that the “wilder shores of derivatives trading” do not tend to be something that most judges are comfortable with. Amongst other things, the Committee (which actually has around 80 issues under consideration) is organising seminars for judges, looking at *pari passu* clauses in sovereign debt reschedulings, evaluating the US *amicus curiae* system, looking at emergency powers in the City etc etc. As we learned at a previous round-table, it is also heavily involved in defending the City on trustee exemption. Busy, clearly; and a lot of interest in what it is up to.

AH.

Central bank cooperation. With Sir Andrew Crockett. February 5, 2004.

Last year, Andrew Crockett moved from Basel to NY – from the BIS (where he had been general manager for nine years, as well as the chairman of the FSF) to JPMorgan. This was an opportunity to share his thoughts on central bank cooperation – and, in particular, how different countries, and groups of countries, treat the Basel process. It was also an intriguing window into how Basel works – and why it works. (Confidentiality is obviously key; the almost total absence of leaks encourages participants to speak frankly, particularly when not even deputies are around.)

A few impressions:

- the consensual, almost collegial, nature of the meetings;
- the willingness to tackle contentious issues – issues that sometimes divide central banks from Treasuries, more than one country from another;
- the efforts that are made to reach out to non-G10 states – sometimes with surprising results (since they may well take positions they wouldn’t be willing to articulate in public); and
- the occasional use of “retreats”, where governors get together off-site to learn about a particularly thorny issue (the derivatives markets being one).

Broadly, the meetings are successful, and the BIS must be right to believe it has played a role in the long(ish) period of systemic stability we have enjoyed. But there will be issues for the future. The big one is how to bring “future giants” like China and India into the dialogue; at present, the G10 still runs Basel, though there have been important initiatives to develop an Asian equivalent in Hong Kong. That should be watched closely, and may indeed be one of Crockett’s main achievements.

Other issues that are bound to come up include whether the BIS should take a stronger line on FX policy, what role it should have in supervision (given that CBs are generally losing regulatory responsibility) and whether it can maintain its (extremely useful) tradition of collegiality and opacity.

AH.

The work of the Pension Commission. With Adair Turner. February 10, 2004.

Adair Turner (ex-McKinsey, ex-CBI, now a deputy chairman at Merrill) is almost too bright for his own good – but, this time, he has taken on a task that would stretch even Mycroft Holmes. He is chairing a three-member Commission (due to report by September 2005) that is tasked with looking at private sector pensions in the UK, and how they can be made more secure.

This is a broad mandate (even though it excludes public sector pensions), and it puts Turner firmly at the centre of the most important questions of the next few years. As noted, the government has given the Commission a fair amount of time: the work plan was agreed last June, and an interim report will be released later this year. In the meantime, Turner *et al* are working on the demographic issues, the weakness of private savings, the potential of the housing market etc etc. All of this work reinforces a general point: there is a problem, it won’t go away, and tinkering isn’t enough. There are no easy answers (not even immigration – and certainly not simply increasing the retirement age). Moreover, trends over the last couple of years are going in the wrong direction; things are getting worse, not better, and the UK’s relative advantage over other countries is evaporating. The statistics are awesome: 60-70% of private DB schemes are now closed to new entrants, and over the next 20 years or so the number of people in private sector DB schemes will fall three-fold – to be replaced by private individual provision or less generous (and riskier) DC schemes. The result is an enormous shift of risk from the corporate sector to the individual – and an equally worrying increase in the system’s gaps. Too many people have made little or no provision, and it is going to be very difficult to convince them, in the present investment climate, that they should change their whole approach to savings – particularly given the cost of most retail savings products.

All in all, an impressive (but terrifying) presentation. I hope we can schedule another such round-table after release of Turner’s interim report.

AH.

Key issues in global insurance: A tour d’horizon. With Alan Punter (Aon), Peter Vipond (ABI) and Rick Murray (Swiss Re). February 19, 2004.

The aim of this meeting was to summarise the threats facing the global P&C insurance/reinsurance industry, with the intention of generating a series of CSFI meetings. This is an area where we are aware that there is a lot more going on than we can ever cover.

What came out of it? In no special order, our speakers emphasised:

- the industry’s “addiction” to the underwriting cycle – in which short hard markets are followed by long soft markets and suicidal price cutting;
- the industry’s overwhelming need for capital – and the way that capital pours out when markets go down (with the notable exception of Bermuda, where capital has continued to grow largely on the basis of its attractive tax environment);
- the lack of products specifically tailored to contemporary

- risks (insurance, it was said, is good at covering assets, but rotten at covering earnings);
- the astonishingly casual basis on which much business is written (contracts without paperwork, for instance), the lack of contractual certainty that is often involved and the almost amateurish pricing that tends to occur;
- the very different historical records of profitability, sector by sector (though even in historically profitable sectors like motor insurance, investment income is often more important than underwriting);
- the declining role of the brokers (though they are still very significant in some areas);
- the “long-tail” problem – insurers are always liable for the insurance they wrote, no matter when, and courts don’t seem willing to change this;
- the difficulty of regulating such an industry, particularly in a world of risk-based capital;
- the increasing importance of concentrating on liability management since, in the present environment, insurers are not going to be bailed out by soaring investment returns; and
- the development of a highly refined plaintiff’s bar in the US (“sharks with brains”), which is always looking for someone with long pockets to sue over class action suits from tobacco and asbestosis to obesity.

AH.

An investment management perspective on CAD3. With Bill Rattray (Aberdeen Asset Management), Dallas McGillivray (INVESCO) and Michael Kent (Linklaters). February 20, 2004.

This was an attempt to sort out the problems that the UK’s “pure” investment management industry (i.e. that which is not absorbed into larger banking groups) has with Basel 2, CAD3 (which incorporates Basel’s rules into European directives) and, ultimately, with the UK legislation that will apply to regulated institutions in this country. The main problem is pretty clear: although Basel is supposed only to apply to internationally-active banks (and will, therefore, have a very restricted impact in the US), it will hit all European institutions that fall under the Second Banking Directive – and that includes fund managers, who currently operate under an FSA waiver but who, in the absence of that waiver, would be subject to an op risk capital change that might push many of them under.

The FSA is broadly sympathetic, but the UK industry discovered this problem very late in the day – and trying to “reverse engineer” a directive that is already in draft is tough going. Attention is focused on Article 21 and what it says about consolidated supervision, the downstreaming of debt, restrictions on the holding of client monies and the ability of “pure” fund managers to operate in more than one country if they are granted a continued waiver. Some progress is undoubtedly being made; but the “pure” fund manager is not an animal that Brussels is comfortable with. Some in the industry believe that the answer is for Continental fund managers – almost always banks – to “ring-fence” their asset management operations and treat them on a stand-alone, low capital basis. Others think that is crazy: surely, the more important task is to convince Brussels that the

risks inherent in the “pure” asset management model are qualitatively different from (and much lower than) the risks in the conventional banking model. Hence, the CAD3 regime is totally inappropriate.

The industry will probably get the carve-out it needs. But the kerfuffle demonstrates just how the ostensibly liberalising goals of the FSAP tend to evaporate in favour of a series of skirmishes in which the City tries to minimise the damage that even well-meaning EU directives can do.

AH.

Visualising risk: A dinner discussion. February 23, 2004. (With support from M&G/Prudential.)

The aim of this event (which included interlopers from the non-financial world, like Lewis Wolpert and Edward de Bono) was to look at innovative ways of conveying basic information on potential risk and return to non-specialist buyers of retail savings products. No easy answers, and everyone (probably) took away his/her own conclusions. For me, the main message is that it is as important to slap a label on the *buyer* of a financial product as it is on the product itself. It is possible (I think) to summarise the key risk/return parameters of a product in a way that even a Millwall supporter could understand; but whether that product is “suitable” depends on (a) who is buying it (income, stage of life etc), and (b) what is already in the purchaser’s savings “basket” (since portfolio effects may either mitigate or amplify risk). That said, in an internet world, it ought not to be so difficult to provide individuals with their own profile, and to evaluate any number of suitable (or unsuitable) portfolios. Several of the participants at this dinner (for which, thanks to M&G’s Gary Shaughnessy) are keen to follow up.

AH.

The practicalities of money-laundering and AML regulations. With Karen Van Ness (Mantas). February 24, 2004.

Mantas is a hands-on provider of software solutions to AML and KYC problems – but, more than that, it is one of a handful of firms that actually knows something about how money launderers, terrorists, drug barons and other bad guys actually operate. (Indeed, it is a major sponsor of an annual International Money Laundering Conference, and it publishes *Money Laundering Monitor* to keep its clients up to speed.)

Karen Van Ness (subbing for her boss, Simon Moss) is head of AML product development. A former Citibanker, she provided an impressive *tour d’horizon* of what is going on (both formally and informally) in the post-9/11 world. She emphasised that, initially at least, the US lagged the UK – but the PATRIOT Act may change that. FATF, the Wolfsburg group, the pressures to standardise Suspicious Activity Recording . . . a lot is going on, and there is absolutely no sign that anyone of any standing is yet willing to say publicly (a) that money launderers and terrorists eschew banks, (b) that the growing cost of compliance with AML legislation imposes a real burden on both banks and their clients, and (c) that there must be a better way.

AH.

What does the City want from the internal market? With Alexander Schaub (D-G Market). February 25, 2004. (With support from the British Bankers' Association.)

Apparently, Alex Schaub (who took over the Internal Market portfolio in September 2002, having previously been D-G for Competition) has been doing the rubber chicken circuit in the City, trying to get himself up to speed on its concerns. However, he is still a draw: we had an SRO audience (80 plus) for early morning coffee and buns – which is testimony to just how important his portfolio is, and to the City's concern that what used to be D-G XV is no longer that corner of a foreign field that is forever England.

Schaub is impressive, and he says the right things (even if he says them so forcibly as to discourage dissent). Chief among those right things is his belief that the City is “unique” – a pan-European resource. Clearly, to him, the FSAP – “nearly complete already” – is a resounding success as far as it goes, though any judgment must be provisional since we have got to see how it will translate into practice. But, even now, the Commission has to think about the next phase – which inevitably will revolve around implementation and enforcement, though he also emphasised the international dimension. This is bound to be a big issue: Americans were surprised by the EU's interference in the Boeing/McDonnell merger, while Europeans were outraged by the extraterritorial aspects of SarBox. But, on the whole, the biggest problem is bound to be the different legal environments in the EU itself, and the way that they all interpret legislation coming out of Brussels. Again, Schaub said the right thing: “parallelism”, not harmonisation, must be the preferred way forward from the point of view of the Commission (though, he warned, member states often press for full harmonisation).

AH.

“The curse of the corporate state: Saving capitalism from itself”. A round-table discussion on the recent CSFI paper, with the author, Bob Monks. February 25, 2004.

Bob Monks is an elemental force – and this paper (the second he has written for us) is a powerful, politically-charged piece of work that he hopes will have some resonance in the US during the Presidential election campaign. It looks at (and deplores) corporate power as it is applied to the political sector in the US – and proposes at least the beginning of a solution. Monks makes some powerful points:

- the word “corporation” does not appear anywhere in the Constitution;
- power used to be political (and was exercised by politicians), now it is economic (and politicians are just hired hands);
- corporacy and democracy are inevitably at loggerheads;
- the growing tendency of government to run itself like a corporation means that it has never been easier for the US to go to war (there isn't even much need for coalition-building any more); and
- “efficiency obliterates legitimacy” – by which Monks means that outsourcing the key functions of a democratic

society undermines the political consensus which holds that society together.

In his view, corporate money drives out other money and makes it impossible for Congressmen to respond to their individual constituents. What is needed is to disenfranchise the corporation – and then to require the owners of those corporations to exercise the ownership and control functions that they have tended to pass on to intermediaries. (Note: A round-table will also be held on the report in NY. It is scheduled for 12:15-2:15pm on May 25, 2004, at the Harvard Club.)

AH.

Finance for smaller businesses – the role of OFEX. With Jonathan Jenkins and Peter Freeman (OFEX). February 26, 2004.

Over the last few years, we have looked at the VC industry, at University spin-offs, at business angels, at bulletin-board systems for raising equity, and at regional stock exchanges. But this is the first time we have looked at OFEX – the (privately-owned) FSA-regulated market that constitutes the bottom tier of the three tier equity structure in the UK, and which has deliberately targeted the £300k to £2m market. In fact, it is a pretty good story – even though OFEX is itself undergoing fundamental change.

“Divorced” from JP Jenkins, floated on AIM (under the FSA's umbrella), and finally serviced by competing market-makers, OFEX has grown up – and it has bought some pretty experienced talent, with a heavy AIM background, to make it work. The figures are impressive: raise £2m on AIM and the all-in cost is about 22% – on OFEX, it is about 12%. True, liquidity remains an issue; most AIM-listed stocks trade irregularly. But that may change as more companies list from overseas (Australia, Canada and NZ in particular) and as other firms follow the lead of Arsenal FC and Weetabix, both of whom listed recently without any contemporaneous capital-raising. ESOPs may help; OFEX can make it possible for employees to value their stock in the company on a daily basis.

AH.

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