Breakfast Roundtable Discussion
Dining Room A – House of Commons
Wednesday 11 February 2009

Will the massive changes taking place in financial services and their regulation generate the migration of the last global business from the UK and what are the potential economic consequences for UK plc?

Text of Professor Michael Mainelli, Chairman of Z/Yen Group:

Key Points:

- **Global Financial Centres Index – it's our lead to lose;**
- **heritage of treating all comers fairly;**
- **UK now, in strategic planning terms, a "political risk";**
- **be wary of the religion of regulation;**
- **a reasonable, though brave, reaction – more competition (i.e. primary regulation) and open-to-all-comers;**
- **to what should legislators be alert – simplistic, so-called, re-regulation.**

My Lords, Ladies and Gentlemen. It is a privilege to have the opportunity to address you this morning on a key topic: how changing financial service structures affect perceptions of London and the UK, and how you as parliamentarians might react. I shall draw upon the Global Financial Centres Index which my firm, Z/Yen Group, compiles every six months on behalf of the City of London. I will be followed by Doug McWilliams who will explain how crucial financial services are for London and the UK.

Leading Though Shaking

The Global Financial Centres Index has shown over the past two years that London and New York City are neck-and neck as the only two truly global centres. People focus on two frontrunners, but survey-by-survey Hong Kong, Dubai and Shanghai make significant inroads. Whilst all financial centres are taking a hit, things are especially precarious for London.

Treating All Comers Fairly

The heritage of London and the UK is treating all comers fairly – the so-called Wimbeldon effect - the local champion may have little chance, but the judging will be fair. London thrives when it's open to foreigners, from French Huguenots to Hong Kong Chinese. London suffers when it's unfair to foreigners - the expulsion of the Jews in 1290 or the closed shops of brokers and jobbers until 1986.

London has been built on others' mistakes. Eurodollar markets grew swiftly in the 1960s when US tax rule changes meant multinationals found it attractive to leave dollars outside the control of US authorities. Sarbanes-Oxley requirements after 2000 increased the attractiveness of London as a "light touch" regulatory environment. AIM listings increased listings at the expense of NYSE. But when the UK makes mistakes, for example with the shipping industry last year, retribution is non-existent, but exodus is swift.

The UK - A Political Risk

Sure, in the past 18 months or so pessimism has become the new black, but blackest for me is overseas clients claiming that the UK is a big political risk. I ask why. What I get, in heavily accented English, is tax since 2007 – changes in six months to non-doms, capital gains tax, foreign dividends and trusts. Now a proposed 45% tax rate. On access, they complain about visitors' visas, work visas and ID cards for non-EU nationals. Then they mention terrorist legislation used against Iceland. Then they point out that it's difficult to get fair treatment in a country where the government

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controls the banks, whether it's a banana republic or the UK, the courts won't operate fairly. When I defend fairness in UK courts, overseas clients point out the 1992 case, Hammersmith & Fulham Council versus Hazell.

Religion Of Regulation

Market failure comes in three broad categories: lack of competition, information asymmetry/agency problems, and externalities. Wholesale finance certainly exhibits classic signs of lack of competition: an industry that went from 5% of USA market capitalisation in 1990 to 23.5% in 2007 – a quarter of the US economy was pushing paper around? And self-evidently excessive salaries, a banking industry with 2006 profits per employee a magical 26 times higher than the average of all other industries worldwide (according to McKinsey), and a cast list of the top 10 that would be largely recognisable back in 1929: Goldman Sachs, Merrill Lynch, Lehman Brothers (oops), Morgan Stanley, Bear Stearns (oops), JP Morgan Chase, Citi … even last summer - less than 20 global investment banks, 4 auditing firms, 3 credit rating agencies, 3 actuarial firms. Frank Partnoy covers two decades of scandalous abuse of investment banking customers in nauseating detail in his 2003 book, Infectious Greed – and taxpayers pick up the cost.

Regulation has caused overly-large, dangerous banks. Regulation creates barriers to entry, promotes the large over the small, and reduces competitive variation. Financial services regulation is a religion - "regulation failed because you really really didn't believe in regulation. So pray harder." The religious faithful of regulation want to go much further the other way and now seek powers to follow mega-banks, rather than question whether size itself might be a sign of regulatory failure.

When we see market failure we should first try and fix it through trust-busting or anti-monopoly laws – the 1890s in Britain, the 1900s in the USA. Only Private Eye [2 Octboer 2008, page 3] had the guts to call a spade a spade – "Gordon Brown promised to increase regulation to deal with collapsing financial institutions, but his biggest move so far is a massive decrease in regulation" suspending normal competition and takeover rules for Lloyds and Santander.

The Credit Crunch is not amenable to quick fixes but, in today's world of "keep-it-simple-stupid" bullet points, some high-level conclusions include:

- too big to fail is too big to regulate – financial services is a bit special (so are pharmaceuticals, defence, electricity, air travel, shipping, water, …), but the fundamental regulatory tool in all markets is competition and we need to increase competition in financial services, not reduce it;
- increases in regulation reduce diversity – a healthy financial services ecosystem should exhibit diversity, yet society appears to over-value presumed economies of scale in financial services;
- less regulation is just as important as better regulation – what we have here is a failure to regulate, but more regulation is not success;
- government intervention displaces private sector investment, as a multiple – the sooner government activity and funding of financial services returns to a minimal level, the sooner longer-term reforms can begin.

Competition And Open-To-All-Comers

For parliamentarians, I would argue that the focus must be on increasing competition while keeping London open as a market for all to be treated fairly. In fairness (sic), we could emerge in a few years stronger with more international, transactional industries centred on London – mining, film & media, air transport, even shipping could come home.

Long Finance

Over the past two years, people have stumbled and bumbled from incident to event to problem to fix. To move from temporary fixes to permanent solutions we need impertinent questions, such as "how would we know when the financial system is working?" In other words, what is truly our desired outcome. Some answers might be "when a 20 year old can safely enter into a financial structure for retirement" or "when we can sensibly finance a forest" – sustainable financing over 75 to 100 years, not just quickly flipping transactions. The financial system, if not broken, reveals itself

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to be incapable of dealing with the long-term - I would encourage research into the idea of Long Finance

I do believe in the power of competitive markets to make the world a better place. I equally believe that markets are social tools requiring design and oversight to meet their objectives. Yet we must be wary of knee-jerk re-regulation, competition is the best regulation and other regulation must be limited, even if you, like me, think that financial services itself is culpable.

Thank you.

Discussion points:

- role of auditing firms, the complete waste of time in 2007 and 2008 of core banks' balance sheet and going concern audit processes – need for a serious look at more competition;
- role of credit rating agencies and explanation of SEC's part in Nationally Recognized Statistical Regulatory Organisation (NRSRO) status – why any special status?
- need to distinguish "supervision", "regulation" and "competition" in discussions;
- looking carefully at credit markets in particular and how to inject more thinking into the "unthinking" behaviours encouraged by regulation;
- how to inject more competition in UK retail quickly and cleanly, e.g. Professor Mainelli's suggestion of nationalising UK banks with majority shareholding by government (majority shareholding not quite the same thing as ownership), then privatising in slices, e.g. RBS in 100 slices. These slices could be restricted and go back a bit to mutuals or building societies, e.g. a portfolio of Newcastle loans and mortgages, a portfolio of Somerset loans and mortgages. The early slices should be keenly priced, encouraging take-up, as was done in the mid-1980 privatisations. The later slices, e.g. remaining 23 out of 100, are equivalent to the "bad bank" or "toxic loan guarantee".
- questioning the limits of competition – would a rating agency or auditor respond?
- pondering the need for social sanctions, e.g. naming and shaming, as well as potentially removing the ability to participate in markets for a few score of individuals;
- is the UK's tripartite approach (Treasury, FSA, Bank of England) appropriate – key point being that none of the above are responsible for competition in financial services?

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