The Said Business School is a powerhouse of financial expertise. Our faculty publish in top journals, speak at major academic and practitioner conferences, and advise corporations, public bodies and governments. We have many distinguished alumni in the financial world (see page 12), as well as those who are using the financial acumen they acquired at the School to succeed in their ventures (see pages 18 and 38); and we attract students of the highest calibre to study on distinctive programmes such as the MSc in Financial Economics and the Diploma in Financial Strategy.

Our finance faculty are pushing the boundaries of business thinking, and this issue of Business at Oxford profiles some of this pioneering work: Dimitrios Tsomocos is developing a model that will enable bankers to measure financial fragility (see page 16); Alan Morrison explains why reputation and relationships are still key in investment banking (see page 20); Tarun Ramadorai demystifies the world of hedge fund management (see page 04); and Michael Devereux looks to the future of corporation tax (see page 42).

One of the distinguishing features of finance at Oxford is its multi-disciplinary nature. Earlier this year, we were delighted to announce the creation of the Oxford-Man Institute of Quantitative Finance (see page 07), funded by the Man Group – the world’s largest hedge fund group – to the tune of £13.75 million. Partnering with a finance industry group on this unprecedented scale means that we can bring together researchers from physics, mathematics, computer science, economics and finance, in order to find answers to some of the big questions facing organisations in the twenty-first century.

The intellectual capital of the University is also being brought to bear on taxation issues at the Oxford University Centre for Business Taxation (see page 43). This Centre, funded by The Hundred Group, representing CFOs from the top companies in the FTSE 100, is rapidly establishing itself as the leading centre for business taxation in the world.

Our programmes reflect our innovative approach to the discipline. Nearly half the electives offered on our MBA programme are now finance-related. They incorporate the latest thinking on subjects ranging from capital raising techniques to corporate valuation, and from hedge funds to private equity. These courses are often taught by academics and industry practitioners working in partnership to ensure that cutting edge research is blended with real-life application.

A marked stress on real world finance is also found on the MSc in Financial Economics (MFE) programme, which has proved phenomenally successful since it was founded in 2005. Through practitioner lectures, events and career workshops, MFE students gain an overview of the industry, with the majority going on to secure positions in financial institutions.

Our strength in the area of finance is increasingly reflected in the growing range of executive finance programmes we offer. The Diploma in Financial Strategy, designed to enable finance professionals to reach the highest level in their career, has been a great success attracting senior executives from all over the world. 2008 will see the launch of two short executive finance programmes – the Oxford Private Equity Programme and the Oxford Finance for Executives Programme (see pages 11 and 13).

While this magazine cannot hope to offer a comprehensive overview of all our activities in finance, we trust that it conveys the excitement and energy of the finance community at Oxford.
“HEDGE FUNDS ARE GENERALLY CONSIDERED TO BE RUN BY FINANCIAL WIZARDS IMPLEMENTING HIGHLY SOPHISTICATED INVESTMENT STRATEGIES, WHICH GENERATE CONSISTENT, LARGE RETURNS REGARDLESS OF THE GYRATIONS OF EQUITY AND DEBT MARKETS.”
Hedge funds have attracted a great deal of attention lately, both in the popular press and from prospective investors seeking high returns. The total assets under management by hedge funds are in the neighbourhood of a trillion US dollars, fuelled increasingly by allocations from institutional investors. Hedge funds are generally considered to be run by financial wizards implementing highly sophisticated investment strategies, which generate consistent, large returns regardless of the gyrations of equity and debt markets. These amazing characteristics, of course, come at a price – hedge fund managers are notorious for charging fees that are linked to the performance that they generate, generally 2 percent of assets under management, and 20 percent of any upside.

In financial markets, when something looks too good to be true, unfortunately it usually is. A number of financial economists have been taking a closer look at hedge fund returns, and have found that they are highly correlated with equity, bond, and credit markets. The reason that this isn’t immediately apparent is that this exposure tends to...
to be hidden in the tails of hedge fund returns. Put simply, the returns of many hedge funds resemble the returns on selling insurance against a crisis event. In any period in which a catastrophe does not occur, insurance providers perform extremely well, taking in premiums from customers. However, when the catastrophe does occur, the insurance provider is faced with a sudden, large payout. When markets are tranquil, all is well, but when markets crash, hedge fund returns are likely to be extremely low. This is because their returns are often generated by selling crash insurance. Essentially, the returns on hedge funds resemble those of out-of-the-money put options on equities and other asset classes. This has been in evidence in the recent sub-prime mortgage crisis in the United States, with the troubles of hedge funds being accompanied by large corrections in broad equity indices.

Of course, although this crash insurance is extremely common, not all hedge funds are the same. Managers pursue strategies as dissimilar as convertible arbitrage (taking advantage of pricing discrepancies between convertible bonds and the underlying equity of firms), merger arbitrage (betting on the probability that firms announcing mergers will see them through to completion), and pairs trading strategies (which seek to benefit from convergence in the prices of “twin” stocks, potentially in the same industry), to mention just a few. However, there is one remarkably robust finding which holds regardless of the specific hedge fund strategy under scrutiny: it is possible to replicate a large fraction of hedge fund returns using publicly available instruments.

“There are few truly talented hedge fund managers – approximately one-fifth of the number we analysed.”
In May 2007, the University of Oxford and Man Group plc announced the creation of the Oxford-Man Institute of Quantitative Finance. The Institute is intended to become the world’s leading interdisciplinary academic institute for research in quantitative finance, with a particular emphasis on alternative investments.

Dr John Hood, Vice Chancellor of Oxford University, said: “The University is delighted to build on its strengths in computing, economics, mathematics, engineering and statistics to create the Oxford-Man Institute. The initiative will help develop the next generation of academics in the field of alternative investments.”

“Man Group, the world’s largest hedge fund group, is the sole provider of the core funding for the Institute. Man’s initial commitment to the centre will be for £13.75 million. Man will allocate £10.45 million for the Institute in the initial five years and an additional £3.3 million for an endowed chair, to be called the Man Professor of Quantitative Finance. In addition to its financial contribution, Man Group will house its own research laboratory in the same building as the Institute.”

At this point, scepticism is probably warranted. If hedge fund returns are so easily replicable, and their managers are doing nothing that generates value in excess of easily replicable trading strategies, then why has everyone been making a fuss about them? Two academics at London Business School, William Fung and Narayan Naik, one at Duke University, David Hsieh, and I set out to investigate this question. The answer is that there are a few truly talented hedge fund managers – approximately one-fifth of the total number of funds that we analysed. These hedge funds are less likely to be liquidated than their less talented counterparts, so the business risk of investing in them is lower. They are also capable of consistently generating high, non-replicable returns, year after year.

While this is definitely good news if you are a prospective investor, the bad news is that sophisticated investors are very good at spotting these talented hedge funds. They inundate these funds with more money than they can handle. We discovered that total capital flows to the outperforming hedge funds dwarfed those to the replicable hedge funds, by a factor of three over the last decade. This wall of money had negative consequences for the star performers. Outperforming funds that received relatively high capital inflows struggled to generate future non-replicable performance. This last finding is unsurprising if you think that there are real constraints on the capacity of managers to come up with good ideas, and realise that mispricings in capital markets disappear once capital is committed to benefit from them.

So what’s the takeaway? The first bit of advice for prospective hedge fund investors is “caveat emptor”. You might be paying extremely high fees for easily replicable strategies that are available far more cheaply. At the very least, it may be wise to pay attention to how the hedge fund under consideration has performed in relation to equity and bond indices. Second, even if you have spotted an unusually good investment vehicle, you should be aware that before too long, others will spot it as well – which will make it less attractive in the future. Finally, none of this means that there aren’t some genuinely smart investors out there; it’s just that the search for them is hard, and even when you have found one, you should constantly re-assess your investment.

Tarun Ramadorai is Reader in Finance at the Said Business School.
“PRIVATE EQUITY OWNERS TYPICALLY TAKE FULL CONTROL OF THE COMPANY. THEY ESTABLISH EXTREMELY SHARP INCENTIVES FOR THE MANAGEMENT, AND THEY RECRUIT THE BEST TALENT TO EXECUTE THEIR VISION.”
Although increasingly important in all the major economies, private equity is a sector that many people still know little about. This is not surprising. The amount of public information about the transactions, the performance and the activities of private equity funds is limited. But the amount of money raised by these funds over the last few years has been enormous. In 2006 alone, more than $400 billion was raised by private equity funds. This article lifts the veil on this sector and looks at whether those who work in private equity really are the “new kings of capitalism.”

By: Tim Jenkinson

THE NEW KINGS OF CAPITALISM?

ARE PRIVATE EQUITY MANAGERS REALLY ADDING VALUE, OR ARE THEY JUST OLD-FASHIONED ASSET STRIPPERS?
WHAT IS PRIVATE EQUITY?
Definitions differ, but in discussing private equity, this article refers to the entire asset class of equity investments that are not quoted on stock markets. So the private equity class stretches from venture capital, working with really early-stage companies that, in many cases, will have no revenues, but potentially good ideas or technology, right through to large buyouts, where the private equity firm buys the whole company. Most of the money in these funds comes from institutional investors such as pension funds, endowments and insurance companies, although many high net-worth individuals also invest directly or through fund of funds intermediaries. The majority of the pure private equity funds are structured as limited partnerships. Essentially, they are tax-efficient investment vehicles, almost always with a ten-year life.

BUY-TO-SELL
A critical aspect of private equity funds is that they are not investors who buy to own the companies for the long term – they are buy-to-sell investors. They want to make their investments, create value, and then exit. They are judged on two measures of performance. The main one is their cash-on-cash returns. Whatever sums they commit, the investors care about how much they get out, net of all the payments to the fund. The second performance measure is the internal rate of return (IRR) that investors achieve, which depends on how long it takes for the investors to get their money back. Given these performance measures, a private equity firm has sharp incentives to create value, to exit the investments, and return the money to the investors.

WHAT OF THE RETURNS?
Has private equity been a good investment? The answer is perhaps surprising. For instance, looking at the European market over the last 25 years, the evidence suggests that returns have, on average, been unremarkable and, in some cases, downright disappointing. These disappointments have been greatest at the early-stage venture capital investing where, on average, investors have barely received their original investments back.
However, this hides the real story, which is that funds differ significantly in their performance – and not just by a couple of percentage points, as would be the case with traditional unit trusts or mutual funds. An interesting exercise is to stack up the funds in terms of their returns and look at the fund which would be ranked at the 25th percentile – very good performance but not some outlier. Within Europe, the IRR on this fund has, on average, been 20 percentage points higher than the corresponding fund that would be ranked at the 75th percentile. So the real message is that if you are investing in private equity, fund selection is everything.

Things look a lot brighter when considering the returns earned by buyout funds. For example, in Europe over the past 25 years, the average returns have been around 10 percent per annum. The average return of the top-quartile funds have been nearly 30 percent per annum. The prospect of these sorts of returns explains why investors are putting more and more of their portfolios into private equity. As you might expect, in recent years the flow has predominantly been into buyouts rather than venture capital.

HOW DO PRIVATE EQUITY FIRMS ADD VALUE?

Again, the story is different in venture capital and buyouts. In a typical early-stage company, the venture capitalist is working closely with the entrepreneur, providing not just finance, but also mentoring, access to networks, business discipline, support services and so on. The venture capitalist typically sits on the board of directors and, although not often in overall control, has considerable influence over the company, its strategy and the entrepreneurs. For this, the venture capitalist often needs industry-specific knowledge, in part to shape the strategy of the firm, but also because his or her networks can enable collaboration with potential suppliers or complementary firms, which can be critical to success.

With buyouts, the game is really very different. Buyout funds are looking for existing companies where they can create value. In a typical buyout deal, the private equity fund puts in about a third of the money and the remaining two thirds is debt finance. This is why they are often referred to as leveraged buyouts. The successful buyout firms aim to grow a business, to provide clear strategic direction and prepare it to be sold to a new owner within a few years. For this reason, private equity owners typically take full control of the company. They set tough, but realistic targets and keep management focused on them. They establish extremely sharp incentives for the management in the form of financial returns if they are successful, and they recruit the best talent to execute their vision. It is effectively a different form of corporate governance which is challenging the dominance of stock market quoted companies.

THE NEW KINGS OF CAPITALISM?

Are those who work in private equity the new “kings of capitalism”? Some are certainly paid royally, although success is far from guaranteed. History is littered with unsuccessful one-fund wonders and previously successful firms that have lost their way. It is worth remembering that the riches do not just fall from heaven. The successful private equity firms employ some of the best talent around. Private equity provides a new model in the approach to governance and value creation which is certainly shaking up the thinking of all companies, few of which can feel immune to the reach of private equity. It is not quite a revolution, but it certainly is a challenge to the throne.

Tim Jenkinson is Professor of Finance at the Said Business School.

The Said Business School is launching a new four-day programme for senior executives who want to understand more about private equity. The Oxford Private Equity Programme examines in depth the changes brought about by the new financing and governance models employed by the industry, and offers a comprehensive framework for assessing the implications of private equity for individuals and their organisations. The programme will be led by Professor Tim Jenkinson, Europe’s leading authority on private equity. Tim teaches the highly successful private equity elective on the MBA and EMBA programmes, and recently gave evidence to the UK Parliament’s Treasury select committee investigation into the effects of the industry. There will also be contributions from industry leaders and private equity advisors, and a chance to debate the future of private equity. The programme is being run in association with the CFA Institute.

The first programme is scheduled for 16–19 June 2008. For further information, contact kathy.harvey@sbs.ox.ac.uk.

The Saïd Business School is launching a new four-day programme for senior executives who want to understand more about private equity. The Oxford Private Equity Programme examines in depth the changes brought about by the new financing and governance models employed by the industry, and offers a comprehensive framework for assessing the implications of private equity for individuals and their organisations. The programme will be led by Professor Tim Jenkinson, Europe’s leading authority on private equity. Tim teaches the highly successful private equity elective on the MBA and EMBA programmes, and recently gave evidence to the UK Parliament’s Treasury select committee investigation into the effects of the industry. There will also be contributions from industry leaders and private equity advisors, and a chance to debate the future of private equity. The programme is being run in association with the CFA Institute.

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Sanjay Gupta had already set up and run two successful businesses in the United States before he applied to the Said Business School. He had also participated in a number of non-profit start-ups and had mentored college students at Brown and Yale universities on the start-up process.

So why, with all this experience, did Gupta feel the need for an Executive MBA? “Although I had accrued considerable practical experience through my business ventures, I needed a more solid technical footing, particularly in the area of finance, in order to progress further,” he says, “In particular, I wanted to learn about the mechanics of private placement.”

He selected the Said Business School for a variety of reasons including its integration into Oxford University, its strengths in finance and entrepreneurship and, most importantly, its internationalism. Gupta, who comes from an Indian immigrant family but was born and raised in the United States, was conscious of India as a rising economic power and wanted to build up his business network outside the United States.

“I had gone to a very diverse college in the US,” he says, “but Oxford blew that away. I had been accepted by the Kellogg School of Management as well but, after I visited the two schools, I realised there was no comparison in terms of internationalism.”

Aged 32, Gupta joined the Said Business School’s 21-month Executive MBA programme. He found life at Oxford less esoteric than he expected. “People think it’s a big ivory tower,” he says, “but it’s not like that. There was loads of sport going on. People were much more normal than I thought they would be.”

The Executive MBA programme has proved useful in many ways. Working with Tim Jenkinson, Professor of Finance at the Said Business School, Gupta acquired the skills he had come to Oxford to learn: how to structure a private placement, how to build valuation models, how to negotiate value, and how to evaluate the merits of different exit strategies, from public offerings to leveraged buyouts. In addition, he says, the core finance, strategy, decision science and accounting courses proved incredibly useful, as well as some of the softer courses, such as human resource management.

After completing the Executive MBA programme, Gupta formed a private equity partnership for a group of investors who had become interested in research he had done at Oxford on the Indian economy and its growing connection to the US healthcare marketplace. Geo Health Partners has since invested in a series of start-ups all related to healthcare, and Gupta’s responsibilities now include growing and managing its portfolio of companies in the US and in India.

The international network Gupta built up at Oxford is an integral part of his professional life. “Scarcely a day goes by,” he says, “when I do not have some form of interaction with a member of our class, even though the geographic distances between us are quite great. I can ring up any one of my classmates, who represent some of the most able practitioners in their respective fields, and ask a question about how to do x or y, or get an opinion that has no agenda. Having classmates you can trust – that is priceless.”

AFTER LEAVING THE SAID BUSINESS SCHOOL, ALUMNUS SANJAY GUPTA SET UP HIS OWN PRIVATE EQUITY PARTNERSHIP, GEO HEALTH PARTNERS, WHICH HAS INVESTED IN A SERIES OF HEALTH CARE START-UPS.

BY: ANTHEA MILNES

A HEALTHY INVESTMENT
A new programme aimed at senior executives from non-finance backgrounds is being launched by Oxford University’s Said Business School in April 2008. The Oxford Finance for Executive Programmes is a one-week course designed to help participants increase their impact on corporate decision making and give them the knowledge they need to manage and work effectively with finance professionals.

The programme will be directed by Professor Alan Morrison and will focus on real-life issues currently faced by companies. It will look at how organisations make investment choices and pay for those investments. Participants will learn how to analyse corporate cash flows, how investment opportunities are evaluated, and how financial information is conveyed in financial accounts. It will also include contributions from senior finance practitioners, giving participants the chance to hear how finance directors interact with colleagues to craft corporate strategy and increase shareholder value.

“This will be a highly interactive programme,” says Alan Morrison. “A lot of time will be devoted to applying key concepts in real business situations. Participants will work together to present business plans and will receive feedback immediately on the likely impact of their decisions. This programme is all about increasing knowledge and confidence.”

For further information, contact kathy.harvey@sbs.ox.ac.uk
INTERVIEW

TODAY’S FINANCE DIRECTORS NEED TO BE MORE THAN JUST SCOREKEEPERS. ACCORDING TO JON SYMONDS, FORMER CFO OF ASTRA ZENECA, THEY NEED TO GET BACK IN THE GAME.

on Symonds is not that interested in numbers. “If I had my time again,” he claims, “I’d probably do a psychology degree. There’s always a behavioural dimension to everything in business and numbers aren’t interesting on their own; they are the physical manifestation of human activity.”

It’s a deliberately provocative statement from someone who has spent a lifetime in finance. After qualifying as an accountant with KPMG, Symonds held a number of posts in the chemicals industry before becoming Zeneca’s first finance director. Two years later he helped mastermind the merger with Astra, remaining as CFO until this autumn, when he was lured away by Goldman Sachs. En route he became chairman of the influential Hundred Group of CFOs from the top companies in the FTSE 100. Despite respecting the profession which brought him success, he’s convinced that CFOs who are seen as “the bean counters of the board” must make sure they rise above this stereotype.

“When Astra and Zeneca merged I gave the usual financial update for the board and was halfway thorough when the chairman said, ‘Stop. This is a finance presentation, but you are giving me something I’d expect from the CEO’. He thought of the finance director as the ‘scorekeeper’. I had to break this traditional concept because finance is an expression of business via numbers. It is a route to understanding how the business works. The numbers help you get at the most relevant determinant of future predictability. Ultimately, my job as a CFO was about helping the CEO predict the future better and gain confidence in the financial expression of their strategy.”

Symonds says, however, that there is no excuse for CFOs who are more style than substance or who fail to keep an eye on the data. “There’s no evolution possible without a base of consistently reliable data and predictability. You have to have the foundation. Every three months, as a CFO, I went through the equivalent of an employment interview when I appeared before the analysts, so I had to make sure my presentations had a solid bedrock. Once the market loses confidence, you are finished.”

In order to lead well, CFOs must be able to look beyond their spreadsheets. “I’ve always tried to put someone between me and the functional side of things; one of our young, ‘high potential’ people. I don’t want to be constrained by systems, but that person will be employed to use the data.” It is, he says, a question of understanding the bigger corporate picture. “You think the numbers will present you with your biggest challenges, but rather than thinking numbers you should think motivations and actions. It’s a different language. It’s the fault of most accountants – they think the beautifully presented spreadsheet may have internal integrity, but how do you communicate? You do it in words and pictures.”

Symonds’ advice to any finance director is to spend time among their commercial colleagues and find out what makes them tick. Not surprisingly, behavioural accounting was the subject which grabbed his attention most when he studied the subject himself. But his interest in the psychology of business decisions – financial or otherwise – goes hand in hand with a respect for solid understanding of the systems which help us understand how organisations succeed or fail.

It’s one reason why, during his time as chairman of The Hundred Group, he was so keen to establish a research project looking into the effects of taxation on business. The result was the Oxford University Centre for Business Taxation based at the Saïd Business School, led by Professor Michael Devereux. “The Hundred Group found itself engaging with governments in a discussion about future competitiveness but it seemed to have no rational basis. It didn’t seem to make sense to say “this is our opinion, versus the government view”. There’s a lot of research into personal tax, but could you transform the UK economy by halving the tax rate, as they did in Ireland? No one knows. We felt we needed an independent body to push the boundaries of business thinking and we found it at Oxford.” The Hundred Group is, he says, confident that the Centre has assembled the best group of business tax economists in a centre of excellence.

Recently, Symonds left Astra Zeneca to join Goldman Sachs, after failing in his bid to move from CFO to CEO of the pharmaceutical giant. “I wanted to be CEO, but for a finance-trained CFO to lead 50,000...
“THE NUMBERS HELP YOU GET AT THE MOST RELEVANT DETERMINANT OF FUTURE PREDICTABILITY. ULTIMATELY, MY JOB AS A CFO WAS ABOUT HELPING THE CEO PREDICT THE FUTURE BETTER AND GAIN CONFIDENCE IN THE FINANCIAL EXPRESSION OF THEIR STRATEGY.”

Making the transition from finance director to CEO is, he says, seldom easy. “It’s no accident that it doesn’t happen often. Not many are willing to make the leap out of the comfort zone to talk about customers or clinical trials or whatever.” The pool of talented CFOs is quite small. Sometimes they make better chairmen than chief executives because they have a good grasp of governance issues. “That’s the other thing that has become so important for business. The person in charge of finance does all the knuckle rapping. Never has intellectual independence been more important than it is today.”

According to Jon Symonds, there are three factors which will influence the success of any finance professional: integrity, good grounding in professional standards, and international experience. A fascination with people and the ability to communicate with non-specialists may be what has taken him further than most. “My passions are change and people. I get bored in 30 seconds. That’s why the decision to go to Goldman Sachs wasn’t a difficult one.”

His current role involves developing the bank’s UK client list, adding value where possible to its global pharmaceutical business, and looking carefully at the role of private equity in the drugs industry. “It’s a great match for me. The idea of being able to spend time with the boards of companies feels like a privilege.”

scientists is a big leap forward.”
On the 14 September 2007, long queues formed up and down the UK outside branches of the Northern Rock bank, as anxious customers waited to withdraw their savings. In the space of a few days billions of pounds were drained from the accounts of savers panicked by Northern Rock’s recent request for assistance from the Bank of England, in its capacity as a lender of last resort.

With a banking crisis occurring at least once a decade since the 1970s, it seems all too common a problem. That is why Dimitrios Tsomocos, University Lecturer in Financial Economics at the Said Business School, and Charles Goodhart, a renowned economist and member of the Bank of England’s Monetary Policy Committee from June 1997 to May 2000, are working on a new model of financial fragility which, when fully developed, may help bring some stability to banking systems around the world.

For a large part of the twentieth century banking systems were relatively stable. “There was a massive period of instability in the interwar period in 1929–1933,” says Goodhart. “As a result, bankers became more cautious. Banking became highly regulated, with all kinds of controls over lending, which meant the banks became very safe but not very innovative.”
From the 1960s onwards, however, a variety of interested parties began to lobby for deregulation. “Direct credit controls on banks were removed in the course of the 1960s, 70s and early 80s, which made the banking system more innovative, but also riskier,” says Goodhart. “The number of bank failures was very low between 1935 and 1975, and only really increased from the 1980s.”

Since the relaxation of banking regulations, systemic financial crises have mounted up: the UK’s secondary banking crisis of 1973 and 1974; the US savings and loans scandal of 1985; the stock market crash of 1987; the Asian financial crisis of 1997 and the ensuing banking crises in Brazil and Russia in 1998, followed by the collapse and rescue of hedge fund Long-Term Capital Market (LTCM); the bursting of the dot com bubble in 2000; and now the sub-prime mortgage crisis.

As the Bank of England’s intervention in the case of Northern Rock demonstrates, one role of central banks is to maintain monetary stability, avoid inflation, and maintain and oversee the efficient working of the financial markets through such crises.

“The macro monetary policy approach is not to assess or investigate banks individually, but to investigate how banks interact with other banks, via the interbank markets, where financial institutions borrow and lend money to and from each other,” says Goodhart. “We put special emphasis on modelling the interbank market, and emphasising the heterogeneity and diversity of interactions among banks, and how the corresponding interbank exposures may accelerate and magnify any individual shock from within the system to any single bank,” says Tsomocos.

Northern Rock’s business model relies on borrowing money in the interbank market, where financial institutions borrow and lend money to and from each other. “We think about a macro policy of a central bank and the inflation target; the bank has a model enabling it to measure inflation and predict how it is likely to develop. It also has an instrument to affect inflation: the interest rate,” says Goodhart. “Move on to problems about financial stability, however, and we don’t really have a model which enables us to analyse it. We don’t have a metric to measure it. We can’t really predict financial stability and we don’t really have a very good instrument to affect it.”

Since 1998, Tsomocos and Goodhart have been working on a model to remedy this situation. It is cutting-edge financial research at the interface of microeconomics, finance and mathematical economics. The idea is not to assess or investigate banks individually, but to investigate how banks interact with other banks, via the interbank markets, where financial institutions borrow and lend money to and from each other. “We put special emphasis on modelling the interbank market, and emphasing the heterogeneity and diversity of interactions among banks, and how the corresponding interbank exposures may accelerate and magnify any individual shock from within the system to any single bank,” says Tsomocos.

Northern Rock’s business model relies on borrowing money in the interbank market, but uncertainty in the market meant few banks wanted to lend. Unable to raise money on the wholesale markets, or get its borrowers to repay their mortgages any faster, it was faced with an unfundable “maturity mismatch” and so turned to the Bank of England.

A unique aspect of the Goodhart-Tsomocos financial fragility model is that it looks at the entire banking system in totality, not as isolated units comprising individual banks. Importantly, unlike other models, the Goodhart-Tsomocos model includes the default of loans caused by events within the system: endogenous default. “Any financial instability is some sort of discontinuity in the system, so any model that cannot capture the interactions and cannot model endogenous default and liquidity, is at risk of miscalculation,” says Tsomocos.

By looking at the interaction between banks, Tsomocos and Goodhart are developing a two factor metric that, through assessing the probability of default and percentage changes in banking sector values, can factor in knock-on effects and mimic the functioning of the financial markets. Thus the model can be used to search for indicators of a possible impending financial stability crisis, and for crisis prevention and management. Tsomocos says, “In the final analysis, we need to learn how to live with financial instability and develop the appropriate policy responses.”

The model has been calibrated and tested using data from a number of central banks including the Bank of England, the Bank of Japan, and the Bank of Colombia. More research is required, but Tsomocos and Goodhart are on their way to providing central banks with an invaluable tool that may prevent future financial crises, including the scenes of panicked savers queuing along the street, desperate to withdraw their money.

Dimitrios Tsomocos is University Lecturer in Financial Economics at the Said Business School.

“WE CAN’T REALLY PREDICT FINANCIAL STABILITY AND WE DON’T REALLY HAVE A VERY GOOD INSTRUMENT TO AFFECT IT.”
NEW BEGINNINGS IN UKRAINE

BY: ANTHEA MILNES

“I NEEDED MORE KNOWLEDGE TO DEVELOP THE BUSINESS INTERNATIONALLY. I WANTED TO LEARN MORE ABOUT DEALING WITH INVESTORS AND ABOUT CAPITAL MARKETS OUTSIDE THE FORMER SOVIET UNION.”
Sergey Evlanchik became an entrepreneur in the volatile environment of post-communist Russia. At the time when former Soviet state enterprises were being privatised, he trained as a stock trader and took up employment in the far eastern exchange, based in Vladivostok.

It was while he was there that Evlanchik first saw the opportunity that existed for entrepreneurs to build new businesses in the legal and economic confusion of the transition. So together with a colleague, Alexander Slipchuk, he set up the equity trading company Alfa-Broker in the far east of the Russian Federation, which grew rapidly to become the third largest trading house in the region.

After the collapse of the Russian and Ukrainian equity markets in 1998, Evlanchik re-focused his activities on business development in the industrial sector of Ukraine, where he was born, and on the dairy business in particular, joining together the companies that would subsequently form Ukrproduct Group.

Now aged 27, he decided he could benefit from an MBA. “I needed more knowledge to develop the business internationally,” he says. “I wanted to learn more about dealing with investors and about capital markets outside the former Soviet Union.”

Evlanchik decided to apply to Oxford University’s Saïd Business School. “Oxford had a more entrepreneurial attitude than Cambridge or London, and very modern facilities,” he says, “and yet it was part of an ancient university. Also, unlike London, it offered a one-year programme.” He joined the MBA class of 2002/03. “We had a representative from almost every part of the world in our class,” he recalls. “It was really interesting for me to hear their views and understand their mentality.”

Evlanchik also credits the programme, and the networking benefits it provided, with giving him the courage to lead Ukrproduct to become the first company in the history of Ukraine to become listed on the London Stock Exchange. “It was quite a challenge,” he says. This is something of an understatement, given that the obstacles Evlanchik and his colleagues faced included the chaos caused by the Orange Revolution in Ukraine in late 2004, in which thousands of protestors took to the streets of Kiev in order to overturn the results of a rigged presidential election.

The company was finally listed in 2005, and Evlanchik is still in partnership with the two other Oxford MBAs – Narek Harutyunyan and Dmitry Dragun – who worked with him on the IPO (initial public offering). The team now hopes to grow Ukrproduct, already the market leading dairy producer in Ukraine, to become the market leading food company in the country.

At the same time they have set up an investment bank, Trust Capital Group, which specialises in raising capital for companies from former Soviet Union countries. Having been through the process of listing on the London Stock Exchange themselves, they realise the enormous potential that exists for other businesses to repeat their success.
modern capital-rich and technologically advanced institutions of today. However, at every stage in its development, investment banking has relied upon a central competence: the enforcement of commercial agreements that would be impossible to document and to enforce using only the formal “black-letter” law. The arenas in which investment banks have created and enforced so-called “private laws” have altered over time in response to political, technological, and legal changes. But the assets that investment banks rely upon have changed far less; investment bankers have always relied upon close relationships, repeat dealings, trust, and reputation. These have always been more important, and harder to replace, than financial capital. Investment banks that lose their reputations tend to lose their businesses, too.

It is hard to identify a single rationale for investment banks; like most economic institutions, they were not designed for a specific purpose, but evolved in response to prevailing technological and economic forces. Hence, if we wish to understand the role of the investment bank in today’s economy, and to make sensible statements about its likely future development, we must first understand the historic, economic, legal, and political forces that shaped investment banking. This article, based on our book Investment Banking: Institutions, Politics and Law, addresses these questions by tracing the evolution of the modern investment bank from its origins in the eighteenth-century Atlantic trade between England and America to the present day.

The activities of the earliest investment houses were very different to those of the modern capital-rich and technologically advanced institutions of today. However, at every stage in its development, investment banking has relied upon a central competence: the enforcement of commercial agreements that would be impossible to document and to enforce using only the formal “black-letter” law. The arenas in which investment banks have created and enforced so-called “private laws” have altered over time in response to political, technological, and legal changes. But the assets that investment banks rely upon have changed far less; investment bankers have always relied upon close relationships, repeat dealings, trust, and reputation. These have always been more important, and harder to replace, than financial capital. Investment banks that lose their reputations tend to lose their businesses, too.
“LIKE MOST ECONOMIC INSTITUTIONS, INVESTMENT BANKS WERE NOT DESIGNED FOR A SPECIFIC PURPOSE, BUT EVOLVED IN RESPONSE TO PREVAILING TECHNOLOGICAL AND ECONOMIC FORCES.”
**INVESTMENT BANKING WILL ALWAYS Rely UPON HUMAN AGENCY, RELATIONSHIPS, AND REPUTATION. THE CHALLENGE FOR INVESTMENT BANKS IN THE FUTURE WILL BE TO CREATE WITHIN VERY LARGE COMPANIES THE SMALLNESS THAT THESE QUALITIES REQUIRE.**

**THE ORIGINS OF THE INVESTMENT BANK**
Transatlantic communication in the eighteenth century was slow, contract law was in its infancy, and international commerce was almost unregulated. Atlantic traders at this time therefore relied upon private information about both the quality of goods and the creditworthiness of their suppliers. Their private knowledge, coupled with their personal reputations for probity, enabled them to build complex trading networks within which informal commercial agreements were honoured, even when they had no legal force.

At the same time the constitutional settlement of 1688 strengthened individual property rights and laid the foundations for securities markets. The British Crown was able to borrow unprecedented quantities to prosecute European wars, and markets formed for the resultant government debt. Skills in these markets, coupled with the private contracting abilities of the Atlantic traders, were to be of critical importance to the American economy in the nineteenth century, when America imported the capital it needed to support its own industrial revolution.

**THE RISE OF THE INVESTMENT BANK**
Technological and legal changes in the first half of the nineteenth century precipitated the emergence of fully fledged investment banking. First, contract law advanced to the stage where commercial counterparties could rely upon the courts to enforce predictable and reasonable standards of damages after breach. Second, transatlantic communications improved significantly, firstly as a result of regular steamship traffic, and latterly after the first Atlantic telegraph cable was laid. These factors lowered the returns that Atlantic traders could generate by using their reputations and their counterparty networks in commodity trade. As returns dried up in their traditional commodities businesses, new opportunities opened up for the Atlantic traders as financiers. The development of the American railroads heralded a new era of big business; the capital that they, and later the industrial companies, required was largely raised through bond issues. Capital accumulation in America was insufficient to cover industrialisation, and, as a result, American bond issues were marketed in England and Continental Europe, as well as at home. In this environment, an organisation with close contacts and a high level of trust on both sides of the Atlantic was able to make hay. By the middle of the nineteenth century the Barings, Rothschilds, Browns and other household names had turned their attention entirely away from shipping and commodity trading to finance.

The second half of the nineteenth century witnessed the emergence of most of the investment banks that would dominate the twentieth-century securities markets. During this period, investment bankers started to experiment with the retail distribution of securities, and adopted the advisory role that remains central to modern investment bankers. The modern syndicate emerged, and the investment banker assumed a position at the centre of American economic life.

**LEVIATHAN AND THE INVESTMENT BANKS**
A merger wave in the last decade of the nineteenth century formed the contours of the twentieth-century industrial landscape. It was facilitated by investment bankers, operating, as they had a century earlier, through close relationships, and relying upon their reputations to facilitate the extra-legal contracts upon which large-scale finance rested. However, the bankers’ position at the nexus of the contracts that allocated capital in the American economy rendered them an attractive target for an emerging class of interventionist and populist politicians. Investment bankers were accused of using their power irresponsibly to feather their own nests at the expense of ordinary working people whom they had disenfranchised, and they spent much of their energy in the first half of the twentieth century responding to increasingly fierce demands for state intervention in their activities. These demands resulted in the 1930s in a total reorganisation of the industry, and its wholesale regulation. Only after the collapse in 1953 of an antitrust action brought by the US Justice Department against seventeen investment banks did the state take a step back from investment banking. Changes to investment banking for the remainder of the century were largely driven by technological factors.

**MODERN INVESTMENT BANKS**
Investment banking in the second half of the twentieth century was shaped by dual revolutions in computer technology and in financial economics. Many traditional investment banking activities were transformed, as algorithms and technical prowess were substituted for old-fashioned, people-based, qualitative investment banking skills. These changes had an effect upon business schools. More and more investment banker skills can now be acquired in professional schools; and because banking skills are being more widely disseminated and because computers create economies of scale in their application, competition in investment banking has reached unprecedented levels.

Information technology has transformed securities businesses, but its impact in other areas has been less pronounced. As a result, investment banking today is a rather bipolar activity. At one extreme, investment banks continue to provide the type of relationship-intensive services that they have always sold, in both advisory work and in complex security underwriting. At the other, they are engaged in capital-intensive business that is high-volume, low-margin, and largely commoditised.

Arguably, the high-tech, high-volume parts of investment banking do not sit happily with traditional relationship-intense businesses. Certainly, we see more and more boutique operations concentrating upon relationship businesses. Investment banking will always rely upon human agency, relationships, and reputation. The challenge for investment banks in the future will be to create within very large companies the smallness that these qualities require.
Last year Alan Clark, the European MD of international brewing giant SABMiller, set out to create a revolutionary development programme for his top team. Not the usual practically-oriented business school programme but something visionary and inspiring – “a programme that reached out into the future”. Clark explains his reasoning: “For executives at this level a much broader view is needed of the way the world could unfold and the implications for our organisation. I wanted a long-term look into the future so it would not hit us as a surprise.”

Clark and Richard Waters, SABMiller’s HR Development Manager, approached a shortlist of five leading business schools. They decided to work with Oxford University’s Said Business School, because of Oxford’s long tradition as a seat of learning, its broad-ranging intellectual resources, and the willingness of programme directors Tracey Camilleri and Ron Emerson to engage with SABMiller in the design of an innovative, challenging and complex programme covering a wide range of topics.

The programme, which was delivered to nineteen SABMiller European directors over five days, exposed them to the University’s leading thinkers in a wide range of relevant areas including politics, economics, ethics and science and technology. Sessions included: the challenge to democracy; shifting demographics; the role of Islam; the economic drivers of China, India and South-East Asia; understanding DNA (at the University biology labs where each participant had their mouth swabbed and DNA analysed); stem cells and regenerative medicine; ethical dilemmas in genetics; nanotechnology; climate change; global water resources; and, at the JET labs in Culham, fusion and the reality of alternative energy.

Post-programme, what was the verdict? “An extraordinary way of waking our collective responsibility to the challenges of the twenty-first century,” judged one participant.

Clark believes the organisational returns should be long-term. “It is about stimulating ideas, imagination and creativity, and ultimately we will benefit as an organisation. Strategy involves linking diverse threads and concepts and crafting them back into the organisation.” He is already talking about rolling out the programme by inviting Oxford experts into the organisation to talk to staff and by repeating the programme for a broader range of executives.
Innovation is also high on the agendas of investment banks. Shorthouse sees investment banks continuing to innovate as they strive to provide the best service possible to their clients, and push to strengthen their own businesses. "Almost every year a sector of the markets takes us by surprise, in the sense that it is particularly popular with clients. Last year, for example, commodity-linked trades became popular as an asset type," says Shorthouse.

"The biggest growth area in the last few years has been in credit repackaging and credit risk; credit default swap markets made it possible to take a positive or negative view on the credit outlook of a particular company or institution, and to create products that cater for particular credit risk appetites. Going forward, I still think one of the best bets to make is to focus on the Asian markets, because of their growth. Also the securitisation markets are bound to continue their record of innovation."

One significant change over the last few decades is how technological advances have transformed aspects of investment banking, such as trading and risk management. "Electronic marketplaces enable us to

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**ADAPTING TO THRIVE**

By: Steve Coomber

Investment banks are facing numerous challenges. Products and transactions are becoming increasingly complex, competition within the industry is ever more intense, and technology is transforming daily practice. But David Shorthouse, European Head of Global Modelling and Analytics at Credit Suisse, believes investment banks are changing in ways that will enable them to continue to play a pivotal role in the global economy.

"Today’s investment bank, or financial services company, is usually a collection of many international businesses," says Shorthouse. "If you look at Credit Suisse, we divide up our businesses into three main areas: asset management, private banking and investment banking. In asset management we focus on providing investment returns. Private banking is tailored for high-net-worth clients. Investment banking, where I work, offers securities products and financial advisory services to corporations, governments and institutional investors. It contains numerous businesses such as debt and equity underwriting, sales and trading, mergers and acquisitions, investment research, correspondent and prime brokerage services."

However, recent periods of banking and economic instability, such as the Russian banking crisis and the dot com slump, have highlighted the strategic importance to investment banks of diversification as a means of future-proofing their business. In some cases, this has meant branching out into hedge funds or real estate. "Investment banks have looked to diversify their businesses and income streams; trying to build up businesses and income in many areas – a ‘many eggs in many baskets’ approach. So if there is a downturn it would not hit all their businesses at once."

Innovation is also high on the agendas of investment banks. Shorthouse sees investment banks continuing to innovate as they strive to provide the best service possible to their clients, and push to strengthen their own businesses. "Almost every year a sector of the markets takes us by surprise, in the sense that it is particularly popular with clients. Last year, for example, commodity-linked trades became popular as an asset type," says Shorthouse.

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One significant change over the last few decades is how technological advances have transformed aspects of investment banking, such as trading and risk management. "Electronic marketplaces enable us to
execute better, faster and with less error. They also increase market transparency and enable algorithmic trading systems to be set up," Shorthouse says.

But improvements through technology must go hand-in-hand with employing the very best talent. "Technology is a tool but it still has to be utilised by skilful people," he says. "Technology may well allow us to do new things, such as dealing more efficiently with an increasing number of markets simultaneously. Increases in computing power allow us to put together new financial products and risk management methods and programmes. Ultimately, however, you still need the experience and skills of the people in the underlying businesses."

Shorthouse points out that technological innovations such as algorithmic trading, are just one segment of an investment bank's trading business. There are many more traders who use their knowledge and experience to take a position in a particular market, than there are trading programmes running. "Systems don't guarantee liquidity in the markets – you still have to match a buyer with a seller. There is still that human element necessary to ensure you position yourself well so that you don't suffer during times of illiquidity and market stress. Also, client contact and relationships are a fundamental part of the banking business and that is not likely to change any time soon."

As financial products become more complex, the profile of people working in certain areas of the industry is also changing. "We are definitely seeing a larger proportion of people with a numerical background come into many of the businesses that involve taking on board and understanding risk – risk often has to be managed dynamically. We need people to understand the numbers, what they mean, and plan ahead for what could happen in the markets."

With competition for top talent likely to increase in the future, investment banks are paying close attention to their recruitment and talent management strategies. "There is a real appreciation for bringing in young talent and training them. We are always on the lookout for promising graduates. We will train them on the job, expose them to the markets and clients, rotate them through a number of different businesses, and help them realise well-rounded skills," says Shorthouse. "During the last downturn firms cut people very quickly and were not in the best position to take advantage of the markets when they improved, so we have to take the longer view." So while the effects of technology and the need to diversify and innovate will change the form of investment banking, in substance it will remain a people business.

One other productive area for banks in the future, believes Shorthouse, is building strategic ties with business schools. Credit Suisse has developed a close relationship with Oxford University's Said Business School, where it sponsors the Oxford Finance Research Centre. "An investment bank can get a tremendous amount out of a relationship with a business school like Saïd," says Shorthouse. "We benefit in terms of collaboration and interaction on the research side, and also through training and recruitment opportunities. We are looking into training company employees there; and we can help the School by providing feedback as to what type of skills we think the students coming through their system should have."

Credit Suisse has sent some of its business heads to give talks to students on the Oxford MSc in Financial Economics programme, as well as providing speakers for the programme's senior practitioner series. On the research side, it has held seminars with some of the School's finance academics, and has taken on summer interns. "It is an ongoing collaboration; definitely something we are going to continue in the future," says Shorthouse.
In the early 1990s, the Fabian socialist business models implemented by prime minister Nehru following Indian independence gave way to a market-based philosophy, and the Indian economy was liberalised.

“It was a very exciting time,” Tarun recalls. “People wanted to know what was going to happen and what the best way to channel foreign investment was. Economics seemed like the natural thing to do.”

Tarun studied for a BA in Mathematics and Economics from Williams College, an MPhil in Economics from Emmanuel College, Cambridge, and finally a PhD in Business Economics from Harvard University. He subsequently joined Said Business School, where he is now Reader in Finance, specialising in empirical asset pricing and international finance. He currently teaches courses on empirical asset pricing and hedge funds on the MBA and MSc in Financial Economics programmes.

Much of Tarun’s recent research has focused on demystifying hedge funds – investigating their performance, the risks inherent in their returns, and capital formation in the hedge fund industry. “Hedge funds are one of the most glamorous areas of financial markets,” he says. “The current fascination with them stems from the fact that hedge funds are meant to be about very smart people predicting the future direction of an asset such as a share, a currency, or even a whole financial market. They are the rocket scientists of the financial world.”

So are they really that smart? “Some of these people are doing some quite sophisticated, complicated strategies,” Tarun says. However, the top fifth of hedge funds that are performing very well are also getting hit with disproportionately large amounts of cash. Due to capacity constraints, this means that the amount of “alpha” (returns in excess of risk) that they can generate will shrink.

“What this means in practice is that it’s probably not worth your while to go looking for really smart investments and we’re back to the good old academic days in which return is just a simple compensation for systematic risk,” Tarun says. 

As an academic, one should like the fact that the markets are operating in the way we think they should, but it’s kind of sad because you’d like to see some magic!”

Tarun’s research on hedge funds has been published in the prestigious Journal of Finance and quoted in mainstream media such as The Economist. In addition, the UK Institute for Quantitative Research in Finance recently awarded Tarun and his colleagues their best paper prize for “Capacity constraints in hedge fund strategies,” which was published in European Financial Management.

Tarun is currently spending a proportion of his time as lead academic for a proposed Oxford University India Business Centre, helping to shape the intellectual agenda for the Centre and forging links with key stakeholders in India. “If you learn about India, then you can help with whatever roadblocks India confronts during its development,” he says. “At the same time, India is a real beacon of hope for lots of other countries, and learning about India can help us to replicate that in other places.”

As a result of these efforts Professor John Hood, Vice Chancellor of the University of Oxford, and Sunil Bharti Mittal, President of the Confederation of Indian Industry (CII), signed a Memorandum of Understanding on 26 June 2007, confirming their intention to collaborate on establishing an Oxford University India Business Centre, to be located both in India and the UK. Areas of engagement between the CII and the proposed Centre will include policy debates on the Indian economy and the identification of ideas that will help support the Centre’s activities across the business community in India.

“It feels like things have come full circle,” Tarun says, “because now I have the opportunity to go back to India and use some of my knowledge to good effect.”
“AS AN ACADEMIC, ONE SHOULD LIKE THE FACT THAT THE MARKETS ARE OPERATING IN THE WAY WE THINK THEY SHOULD, BUT IT’S KIND OF SAD BECAUSE YOU’D LIKE TO SEE SOME MAGIC!”

ANNOUNCING THE OXFORD INDIA BUSINESS FORUM 2008!
The third annual Oxford India Business Forum will take place on 14 March 2008 in Mumbai. The Forum will focus on corporate governance and confirmed speakers include Paul Sarbanes, former US senator, Michael Oxley, vice chairman, NASDAQ, James Turley, chairman, Ernst and Young, Antonio Borges, vice chairman, Goldman Sachs International, Jasjit Bhattal, CEO, Lehman Brothers, Asia. The Vice Chancellor of the University of Oxford, Dr John Hood, will also attend.
"Once issued, IPOs tend to jump around 10%, reflecting the fact that the shares are priced below investors’ bids. Most agree that this IPO discount is not a free gift and must be ‘buying’ something – but what?"

Initial public offerings (IPOs) earn fortunes for investment banks and their investing clients. At the heart of the IPO business is “bookbuilding”, the name for the way most IPOs are run.

Bookbuilding allows banks to serve clients, but also to exploit them. A recent survey of investors in IPOs suggests that even after the IPO-related scandals of the bubble period, IPO practice is not always in the interests of those who are paying the fees – the owners selling old shares and the companies issuing new ones.

In the first half of 2007, according to Thomson Financial, worldwide IPO volumes were $135 billion, up about 30 percent from the same period of 2006. IPOs are the most lucrative part of the “primary equity” business, which earned banks fees estimated at $10.4 billion in that six-month period. The flow of IPOs has been reduced by recent market volatility but, long-term, it is an extremely rewarding business for banks.

Bookbuilding is like a Dutch auction in which the price of the shares is lowered until there is enough demand, and everyone bidding at, or above, that level gets shares at the highest clearing price. The sellers in the auction are the existing shareholders or the company itself; the bidders are investors, mainly institutions; and the auctioneer is the investment bank. But bookbuilding differs from an auction in two key ways.

First, the price is almost always set below the highest clearing price. Second, the bidders disclose their identity as well as their bid price, so the bank can favour some bidders and blackball others when allotting the shares. Once issued, IPOs tend to jump around 10 percent, reflecting the fact that the shares are priced below investors’ bids.

Most agree that this IPO discount is not a free gift and must be ‘buying’ something – but what? The “academic” view is that the discount is buying from institutions their views on the value of the shares, which the bank and issuer need to set the right price.

The “investment banking” view is that under-pricing is buying for the issuer a choice of investors: if the price were set at the highest clearing price, the shares would be allotted to everyone who bid at least that level, but a lower price allows the issuer, through its bank, to pick and choose.

Finally, the “quid pro quo” view is that the bank is buying for itself the secondary trading business of the investors to whom it allots cheap IPO shares. This is not the explicit arrangement outlawed by the US
Securities Exchange Commission and the UK’s Financial Services Authority (FSA) after the Wall Street Settlement of 2003. Rather, institutions, which can direct their secondary trading business wherever they like, place it with the banks that feed them IPOs. This is an implicit “quid pro quo”, whereby part of the IPO discount is effectively rebated to the bank – over and above their fees on the deal.

My colleague Tim Jenkinson and I have conducted a survey of London-based institutions on just these questions. We found that little information is produced by institutions or revealed to banks during bookbuilding, which casts doubt on the “academic” explanation. We also heard that investment banks tend to allot shares to investors who give those banks their secondary trading business. Now, since these investors are nowadays largely hedge funds, they are unlikely to be the investors the issuer would choose to have as its shareholders. So investment banks are probably not giving issuers the shareholders they want. Instead, our research squarely supports the “quid pro quo” interpretation of bookbuilding.

We are not alone in this interpretation. Issuers have tried in the last few years to reverse the bias against them by adjusting IPO design. For its flotation in 2004, Google promised to run a real Dutch auction, with shares going to the highest bidders, and investment banks excluded from allotment decisions. In the event, the Google IPO was launched in a tough market and it’s not certain that the IPO was, in fact, run this way.

Also in that year, the French company Pages Jaunes was sold by France Télécom in a “competitive IPO”. The company wanted to avoid being the victim of “bait and switch”, whereby the bank dangles a high “potential” valuation in front of the issuer to win the mandate, and then sets a lower price in the deal itself – with “market conditions” always a handy scapegoat. The resulting IPO discount is, of course, part of the “quid pro quo” scenario above. So, rather than appoint the banks months in advance to run the IPO, and see its own influence over the process wane, France Télécom waited until well after the IPO was launched before formally appointing firms. This worked, but “competitive IPOs” since then have had mixed success. The FSA warns that they encourage banks to write inflated research opinions in the hope of being mandated. Market critics say competition is destructive so late in the process, because banks hide bad news from the issuer, for example on market conditions, to avoid looking half-hearted and being passed over for the top role.

The FSA has made it clear that banks bringing IPOs must not connect IPO allotments with other business done with the same clients. Our survey, carried out in 2005/06, suggests the connection then was close and that there was a quid pro quo between bank and investor. So it looks as if the market was ignoring the regulator. If the FSA got tough on this, the rebate would disappear and banks would have to use cheap IPO shares for other purposes, like getting the price right or giving issuers the shareholders they want.

Howard Jones is Senior Research Fellow in Finance at the Said Business School.
SHAREHOLDERS OF PUBLICLY TRADED COMPANIES ARE REQUIRED TO ELECT A BOARD OF DIRECTORS (BOD), WHICH IS RESPONSIBLE FOR THE APPOINTMENT OF THE CEO, AND IS CHARGED WITH ALL THE IMPORTANT COMPANY DECISIONS. IN PRINCIPLE, THE BOD SHOULD FUNCTION LIKE THE LEGISLATIVE BRANCH OF GOVERNMENT, PROVIDING IMPORTANT CHECKS AND BALANCES AGAINST EXCESSIVE CEO POWER. IN PRACTICE, CORPORATIONS ARE RARELY RUN LIKE TRUE SHAREHOLDER DEMOCRACIES AND ARE MORE LIKE AUTOCRATIC REGIMES, WHERE ALL THE POWER IS CONCENTRATED IN THE HANDS OF THE CEO AND WHERE THE BOD IS NO MORE THAN A RUBBER-STAMP ASSEMBLY.

MUCH OF THE DRIVE TO REGULATE THE GOVERNANCE OF PUBLICLY TRADED COMPANIES IN THE PAST QUARTER CENTURY HAS HAD AS A CORE MOTIVATION TO CLOSE THIS WIDE GAP BETWEEN THE IDEAL OF SHAREHOLDER DEMOCRACY AND THE REALITY OF CEO AUTOCRATIC POWER. IN SHORT, THE MAJOR REGULATORY EFFORT IN CORPORATE GOVERNANCE, BESIDES MANDATING DISCLOSURE, HAS BEEN TO LIMIT THE EXTENT TO WHICH THE BOD CAN BE CAPTURED BY MANAGEMENT, AND TO LIMIT THE ROLE OF THE BOD IN CORPORATE CONTROL DECISIONS. THE MAIN VEHICLE FOR MOVING CLOSER TO A MODEL OF SHAREHOLDER DEMOCRACY HAS SO FAR BEEN THE REQUIREMENT THAT COMPANIES APPOINT A MINIMUM FRACTION OF INDEPENDENT DIRECTORS ON THE BOD AND ON IMPORTANT COMMITTEES, SUCH AS THE REMUNERATION AND AUDIT COMMITTEES.

A BASIC PROBLEM WITH THIS APPROACH, HOWEVER, IS THAT THE ANALOGY BETWEEN A NATION’S POLITICAL GOVERNANCE AND DEMOCRATIC INSTITUTIONS, AND A FIRM’S GOVERNANCE HAS ITS LIMITS. THUS IT IS FAR FROM CLEAR THAT SHAREHOLDER DEMOCRACY IS A DESIRABLE GOAL PER SE, AND IS IN THE BEST INTERESTS OF THE CORPORATION AND ITS OWNERS. THE HIGHLY COMPETITIVE AND RAPIDLY CHANGING ENVIRONMENT IN WHICH FIRMS OPERATE CALLS FOR AN EXPERT, Nimble, AND HIGHLY RESPONSIVE GOVERNANCE, Which DOES NOT ALWAYS LEAVE MUCH ROOM FOR LONG DELIBERATIONS AND WIDEspread CONSULTATIONS.
Moreover, even if it is desirable to move closer to a model of shareholder democracy, it is not obvious that the best approach is to require greater BOD independence. Directors who are unrelated to the firm may lack the knowledge or information to be effective monitors. But more importantly, the BOD serves a dual role of determining and deciding the overall strategy of the firm as well as monitoring management on behalf of company owners. When too much emphasis is put on BOD independence, the board will not be able to play its strategic advisory role, as it may lack the expertise to make informed decisions, and management may be reluctant to share information with the BOD which could be used against it.

This is why many commentators view independent director regulations with scepticism. In addition, most of the empirical research on the effects of BOD independence has not found much evidence that a higher proportion of independent directors translates into better performance. The evidence in support of independent director regulations is mainly that more independent BODs are more likely to dismiss a CEO following poor performance, and that there is some positive stock price reaction on news of the appointment of an independent director. However, most of the evidence points the other way and suggests that there is no significant relation between firm performance and board composition.

To highlight the inherent conflict between the strategic and monitoring roles of the BOD, we introduced a reduced-form BOD into a simple mathematical model of the firm. In this model the BOD is reduced to a single actor, who may be more or less biased towards management. If the BOD is more biased towards management it is able to better fulfil its strategic role, but this at the expense of more lax monitoring of self-dealing by the manager. Vice versa, if the BOD is more independent it is good at monitoring managerial or insider self-dealing, but this comes at the expense of a worse strategic input.

Using our highly simplified model we are able to address the basic question of when board independence is desirable; in particular, how the requirement of BOD independence meshes with mandatory disclosure regulations and with ownership concentration. We then refine our analysis of the BOD by explicitly modelling information exchange among BOD members and group decision-making. In this more elaborate model of the BOD, we are able to address the issues of how information exchange may be facilitated and how the BOD may be able to make more informed decisions. Within this model we are also able to explain why the BOD is more likely to intervene only in crises and otherwise gives management the benefit of the doubt.

What emerges from our analysis is that there is no golden rule for the composition of the BOD. As management is biased towards stacking the BOD with insiders there is a role for intervention and for requiring a minimum number of independent directors. However, this number should be lower the more stringent are disclosure requirements, and also the larger is the stake of the manager or the controlling shareholder. Also, if shareholder access to the proxy is increased (as in the failed SEC proposal of 2003, under which shareholders would have the right to nominate candidates off the company slate under some circumstances), then there is perhaps less need for a strict rule on the proportion of independent directors.

Policy intervention in corporate governance sometimes takes the form of limiting managerial power on all fronts. This is especially the case following a major scandal. But this is also the outcome of a policy process where each intervention is discussed on a piecemeal basis. There are then always advocates for more interventionist policies debating with those in favour of less intervention. Our model illustrates that this is generally not a good policy approach. When more disclosure is required it is possible to give managers more discretion in the appointment of directors. The risk with increasingly limiting managerial power on all fronts is that more and more firms will choose to delist. Thus, the new buyout wave in the US could be a reaction by some firms to the more interventionist policies post Sarbanes-Oxley.

This article is an edited extract from the 2007 Clarendon Lectures in Finance given at the University of Oxford in June 2007. The lecture was given by Marco Becht, ECARES, Université Libre de Bruxelles, Patrick Bolton, Columbia University, and Ailsa Roell, Columbia University.
The past decade has witnessed an unprecedented and dramatic surge in UN peacekeeping operations—be it in the Balkans, Haiti, Congo, the Middle East or Iraq. Predictably, at the same time, the costs associated with this critical UN function have spiralled. From just over a few billion dollars in the late nineties, the cost of UN peacekeeping had swollen to well over five billion dollars by the end of 2006. That’s without considering operations in Darfur, which are likely to add an additional $2 billion to the pie.

In summer 2006, the General Assembly of the United Nations instructed the office of the then Secretary General, Kofi Anan, to undertake a study. It involved an in-depth analysis of the UN Support Account—a $185 million budget that funds a clutch of departments at UN Headquarters, which provide administrative and operational support to peacekeeping operations worldwide.

Three of my fellow MBA students—Susana Pinheiro, Dapo Olagunju and Ruchika Singhal—and I were lucky enough to carry out our strategic consulting project at the UN, supporting this study. Our project was the offspring of official recommendations made by two oversight committees at the UN—the Advisory Committee on Administrative and Budgetary Questions (ACABQ) and the Office of Internal Oversight Services (OIOS)—both of whom asked the Secretariat to re-examine the evolution of the support account with a view to redefining the boundaries of evaluation, if necessary.

What was clear from the outset was that the sharp increase in UN peacekeeping costs in recent years has not been without controversy. While there has been near unanimity among member states on the need for greater UN intervention in conflict zones, few states, if any, sympathised with the need to tolerate an equally dramatic surge in the support account budget required to backstop peacekeeping on the ground. What was more, despite a clearly recognised correlation between the level and the complexity of the peacekeeping missions and the level of the support account, there was no defined formula or model representing this relation.

This problem threw up more questions than answers. Did the support account have to bloat each time troop deployment increased? Was there a transparent way to capture the complexities between increased demand on the peacekeeping...
A new elective on financial risk management was delivered by Mirela Predescu and Celine Rochon for the first time in Trinity term 2007. The aim of the course, which will run again in 2008, is to study how risks are identified, quantified and managed by financial institutions. It helps students to grasp the essentials of the risk management function, in particular the portfolio of risks that the organisation is taking and plans to take, whether or not the risks are acceptable, and if not, what actions are being taken.

The course first presents the financial instruments that are traded by firms to manage their risks. It then investigates how exposures to interest rates can be managed, through an incursion into interest rate theory. Volatility and value at risk are defined and different calculation models are studied. Market risk, credit risk, liquidity risk and operational risk are all considered; and the course also includes discussion of the lessons that can be drawn from big financial losses by financial and non-financial institutions.

Celine Rochon comments: “In light of the recent financial market turmoil, the importance of the study of financial risk management practices cannot be overstated.”
ManiPulating WHEN DOES MARKET SPECULATION TURN INTO MARKET MANIPULATION?

Attempts by traders to profit from market manipulation are probably as old as markets themselves. In Confusion de Confusions, a book picked by the Financial Times as one of the ten best investment books ever written, De La Vega (1688) offers a first-hand account of seventeenth-century manipulation on the Amsterdam Stock Exchange: “Manipulators would falsely bid up the prices of stocks through a variety of artifices, including ‘painting the tape’ (reporting false trades to convey the illusion of activity) and the spreading of overly optimistic news.” Although most people have an intuitive understanding of what constitutes manipulation in the context of trading, a ready definition proves elusive.
Normal, non-manipulative speculation is based on a trader’s expectation that he can predict future price movements with some accuracy. This could be because he has a superior understanding of the true value of a security, or because he can predict how other traders in the market are likely to behave in the future. The trader thus takes a position at some point in time and waits until, hopefully, prices move in the right direction so that he can unwind his position at a profit.

When a trader manipulates the market, he attempts to influence prices. If he succeeds in doing so, he may be able to trade profitably without any ability to predict the prices that a security would have obtained in the absence of his manipulative actions. This, of course, is not quite enough to constitute manipulation, since in some sense even a regular speculator may try to influence prices, for example by building a position slowly over time so as to minimize the price impact of his trades. Manipulation is therefore typically associated with more sinister ways of influencing prices.

Broadly speaking, one can distinguish between three types of manipulation. Firstly, manipulation may be action-based. This requires that the trader be able to affect the fundamental value of the security. This may often be the case, for example, because a person is in a privileged position vis-à-vis a company. For example, a politician may buy the shares in a company to which he subsequently awards a profitable public contract. Secondly, manipulation may be information-based. In this scenario, in addition to taking a position, a speculator deliberately spreads (mis)information about the security, for example by spreading rumours or posting bulletins on stock picking web-sites. Finally, when the speculator takes no other actions than merely trading in the stock – albeit with manipulative intent – then manipulation is said to be trade-based. This may occur, for example, when a trader holds a position in a derivatives contract and trades in the underlying around the settlement date so as to affect the derivative’s settlement value.

In practice, the most straightforward way to make money from manipulation is probably action-based. However, few individuals are likely to be able to take advantage of this possibility. Moreover, this type of manipulation is typically outlawed by insider trading legislation. It is therefore arguably somewhat less relevant in those countries that enforce insider trading laws.

The ease with which information-based manipulation is possible depends crucially on two factors. Namely, how gullible the investing public is, and how many people disseminate correct information. In the early years of the Internet, thanks to gullible investors, fifteen-year-old Jonathan Lebed made millions with the simple “pump-and-dump” strategy, that is artificially inflating stock prices through false hype in order to sell at inflated prices, or artificially deflating prices to buy stocks cheap. There have been recent reminders of this: in separate incidents, Lucent Technologies, the telecoms network equipment giant, and Emulex, a computer network hardware vendor, saw $7.1 billion and $2.6 billion wiped off their respective stock market values within hours of bogus press releases appearing on the web. The NEIP, an obscure nearly bankrupt company, saw its stock price rocket up by an impressive 106,600 percent in a matter of days, thanks to Internet message boards.

In a recent paper, Han Oszolyev and a colleague demonstrated that it is enough to have a small number of gullible investors to render rumour-based “pump-and-dump” strategies profitable. Also, intense regulatory enforcement, which makes dishonest rumour-mongering costly, may not necessarily curb pumping-and-dumping: rumours are worth as much as they cost to produce, and thus the presence of regulatory enforcement may give credibility to rumour-mongers, rather than deter them from creating false hype.

In another paper, Alexander Gümobel and a colleague demonstrated that purely trade-based manipulation may be possible even if there are no gullible investors in the market. The main insight derives from the fact that in certain circumstances, trade may affect the underlying security value – not unlike in action-based manipulation, except that the only action affecting value is the trade itself. This type of manipulation is therefore not covered by insider trading legislation.

This is how it works. Suppose the investment behaviour of a firm can be adversely affected by a fall in its stock price. This may be the case, for example, because access to capital becomes more restrictive, or because management may infer negative information about its proposed strategy from the stock price drop. If this is the case, then a speculator can establish a short position in a stock, and then subsequently sell more shares so as to drive down the firm’s stock price. This can generate a self-fulfilling prophecy, because the drop in the share price now leads to a cancellation of a potentially profitable investment opportunity. This further reduces firm value and allows the speculator to close out his short position at a profit.

This type of manipulation can only be carried out profitably via short sales: that is because manipulation destroys firm value – something that only a trader with a short position can gain from. This raises the question whether short sales should be regulated. Clearly, speculators’ ability to sell short a stock has the desirable side effect that negative information can find its way into stock prices more effectively. On the downside, an established short position provides its holder with an incentive to damage a firm. A potential way to limit this problem would be to require that short positions be disclosed once they reach a certain magnitude. In a way such a rule would merely mirror disclosure requirements that have been applied to long positions for many years.

As history shows, markets have always been susceptible to manipulation. Increased regulation has made some of the more extreme cases of manipulation, like insider trading, more difficult. But the question remains whether additional, carefully formulated regulation can still improve market conditions without stifling legitimate interest in trading. Perhaps Mark Twain put it best in his novel, Pudd’nhead Wilson, when he remarked: “October. This is one of the particularly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February.”

Alexander Gümobel and Han Oszolyev are University Lecturers in Finance at the Said Business School.
Students, researchers and local entrepreneurs were given the opportunity to turn the tables and quiz a panel of experienced venture capital investors at the “Conversations with Investors” event at the Said Business School on 31 May 2007. This is what the experts said would-be entrepreneurs can do to make themselves more attractive to investors.

ANTHEA HARRISON
INVESTMENT DIRECTOR
AT NESTA (NATIONAL ENDOwMENT OF SCIENCE, TECHNOLOGY AND THE ARTS)

NESTA provides early stage funding, investing a maximum of £500K over several rounds per company. Harrison believes that securing successful investment comes from being able to prove you can learn very quickly. “If you are in the early stage of a company which is also in the early stage of its own market, success is all about how fast you learn and how fast you can learn from your mistakes in order to get ahead of competition,” she says.

With a background in corporate finance and venture capital, Harrison has worked for the likes of Charterhouse, Lloyds Development Capital, and Deutsche Bank’s Emerging Markets Division looking at investments in Latin America. She believes we could learn from American business attitudes. “There is a significant difference between the US and UK. Americans often consider failure a rite of passage and give credit for previous attempts and experience,” she says. “A negative experience can provide a more powerful learning curve than positive experience. We all know this from our private lives but the British still tend to think of it as a business taboo.”

The key to this, Schwartz believes, is having a clear business plan. “Keep it simple,” he says. “Make sure the executive summary is short and understandable – there’s nothing more off-putting than grandiose concepts with no basic sense.”

Finally, do your maths. “It sounds obvious,” he says, “but we want to see that numbers and targets are realistic but ambitious in an appropriate way.”
Rob James stresses that above all entrepreneurs must be comfortable with their investors and vice versa. “Venture capital is much more of a partnership than simply financial backing. You have to be sure of the people you’re getting into bed with,” he says.

Even in the early stages James believes in securing reputable investors. “It’s not just about getting any money but the right kind of money,” he explains. “I once saw a very good management team with extremely good technology and interesting markets, but their early stage investment came from an unfamiliar source overseas. As a later round investor representing UK institutional money, I was never going to be comfortable with where that early stage money had come from.”

Esprit Capital provides venture capital for European technology, media, telecoms, life science and medtech companies, and is attracted by good quality intellectual property. “Young companies must have a credible argument as to why their technology will be a world leader,” says James. “Oxford Immunotec was a small diagnostics company when we invested in it two years ago. Now it leads diagnostics for latent TB. There are some 30 million traditional TB skin tests done annually, most of which are inaccurate. Oxford Immunotec had disruptive technology – technology to replace the skin test. So as an investor buying into this field there are only two choices: the old or new technology.”

Martin Chilcott
MANAGING PARTNER OF MELT WATER VENTURES AND CEO OF PLACE GROUP LTD, WHICH AIMS TO TRANSFORM THE PERFORMANCE OF THE UK’S STATE EDUCATION SYSTEM

“Entrepreneurs are nearly always wrong,” states Martin Chilcott. “They may start off with a clear idea but it’s only when they take it to markets that they realise they were wrong. What entrepreneurs really need is the ability to adapt. Meltwater Ventures works in an area where markets change very fast. New technologies come on board everyday and we need management teams who can learn faster than the market.”

Meltwater Ventures operates in partnership with Oxford University’s Environmental Change Institute and as a clean-tech investor. “We don’t invest in technology,” says Chilcott. “We deal in solutions that may involve new technology but only when it’s part of a whole solution.”

Simply Green is one of Chilcott’s new investments: a service to householders who want to reduce their carbon footprint. This involves a call centre that provides a home audit detailing how much householders can save annually in energy and expenses. The saved money goes towards a mortgage that pays for a green upgrade of the home. “It’s a complete service solution that may involve new technology, rather than simply backing technology itself,” says Chilcott.

“One of the big questions I ask of entrepreneurs is: how much pain can you take? What commitments do you have – marriage, kids, school fees?” You have to endure, adapt and learn from mistakes in order to succeed.”

Change Institute and as a clean-tech investor. “We don’t invest in technology,” says Chilcott. “We deal in solutions that may involve new technology but only when it’s part of a whole solution.”
Tom Savage always wanted to be an entrepreneur. As a child, he was more likely to be found browsing the pages of the Financial Times than the Beano, and he started trading on the stock market at the age of 14. However, it quickly became clear to him that using money to make more money did not motivate him, and that he was more interested in the opportunities that money creates to effect positive change in the world.

While an undergraduate at Edinburgh University, Savage started an entrepreneurs’ student society and helped a group of fellow students to raise £25,000 for an expedition to Zanzibar. Their project, to chart and conserve previously unexplored coral reefs in the Western Indian Ocean, formed the basis for Savage’s first social enterprise, Blue Ventures, which he founded together with fellow student Alasdair Harris.

Savage developed Blue Ventures while studying as a CHEAR scholar on the MSc in Management Research programme at Oxford University’s Said Business School. “I remember lots of phone calls from the library and a lot of work after hours. People on my course remember me as being on the phone most of the time!” he says. Blue Ventures has since gone on to become an award-winning NGO dedicated to raising awareness of the need for marine conservation and research.

Looking back on his time in Oxford, Savage says the experience gave him the confidence he needed to go out and network, as well as the skills to develop his ideas. Paul Hannam, an associate fellow at Linacre College, Oxford, is now his business partner and mentor; while Alex Nicholls, University Lecturer in Social Entrepreneurship at the Said Business School, is a patron of Blue Ventures. During his year-long masters programme, he was also inspired by some of the individuals he met: “I actually sat next to Jeff Skoll at a dinner and he was a really humble, interesting and sincere guy,” he recalls.

Since leaving the Said Business School, Savage has set up three new ventures which have all had an environmental focus. They are Travelroots, an eco-tourism travel agency, and Tiptheplanet.com, a user-generated
website offering visitors environmental advice. More recently, Savage has attracted private investment to create Bright Green, a recruitment business focused on the environment, which seeks to place staff in environmental and corporate social responsibility jobs in the private sector.

Aged 27, Savage is a rising star of the growing social entrepreneurship movement. In 2005, Blue Ventures and its partners in Madagascar won a UN SEED award, an initiative run by the IUCN, UNEP and UNDP to find the most promising, innovative and entrepreneurial partnerships for sustainable development, and more recently won the UN Equator Prize. Savage has worked with Ed Miliband, previously minister for the third sector, and currently heads up Enterprise Insight, the Social Enterprise Campaign, a government-backed initiative. In 2007, he won Young Social Entrepreneur of the Year Award in the New Statesman Edge Upstarts Awards 2007 and was featured as a case study in Gordon Brown’s book, *Everyday Heroes*.

Christopher North, another MBA student commented: “The course combined fantastic panel discussions, stimulating material on likely and unlikely scenarios for the future, and covered a wide range of issues relating to energy technology, energy security, energy supply, and climate change. The course stimulated our interest in and awareness of the commercial opportunities presented by these developments, as companies, communities, and organisations seek to ‘go green’ and adapt to change.”

“One of the criticisms frequently levelled at MBA students is that they think they know all the answers,” says Stephan Chambers, MBA programme director. “This capstone course recognises they don’t. It is our job to teach them the rules of the games being played today and get them to see there are rules that are being written now.”

Angela Wilkinson, a director at the James Martin Institute for Science and Civilization, who was responsible for delivering the course said: “In equipping our MBA students with scenario skills, our aim is to excite them about the value of learning from the future and the challenges of acting with an open mind, rather than to train them in any particular technique. We believe such education is pivotal in their future success as leaders.”
“LAWSYERS CAN OFFER AN INDEPENDENCE OF MIND AND ABILITY TO GET TO GRIPS WITH A PROBLEM QUICKLY BUT MAY NEED TO ADD MORE SKILLS BEFORE THEY CAN CONTRIBUTE FULLY.”

WHERE HAVE ALL THE LAWYERS GONE?
WHEN IT COMES TO THE
BOARD OF DIRECTORS AT
MAJOR LONDON FIRMS, THERE
IS ONE GROUP CONSPICUOUS
OVER FOR LAWYERS WHEN
I'm in enough trouble already”.

It doesn’t anyone want a
City solicitor on their board?
London law firms are some of
the most successful in
the world but very few of their employees
get a good job when they retire from practice
in their 50s. Former senior partners are
not represented on the board of the
Financial Services Authority or the Court
of the Bank of England. In the United
States the position is very
different. As the Financial Times reported
earlier in 2007, chief executives with law
degrees are becoming more common as
regulation increases. Although the tendency
of lawyers to be risk-averse is recognised,
so are the lawyer’s analytical ability and his
or her trustworthiness in a crisis.

The subject aroused interest in the City
firms – particularly from the senior partners!
Of the 50 who came to the seminar at the
Saïd Business School, approximately 30
were City lawyers and the rest from a wide
variety of backgrounds. Business was
represented by Bob Ayling, former chief
executive of British Airways, and Clare
Spottiswoode, non-executive director at
British Energy; the public sector by Pam
Chesters, chair of the Royal Free Hampstead
NHS Trust, and Eve Salomon from the Better
Regulation Commission; and the voluntary
sector by David Isaac, chair of Stonewall and
Modern Art Oxford and a partner at Pinsent
Masons. The speakers also included Mairi
Eastwood from Praesta, who is an executive
coach, and Simon Kingston, a headhunter
from Russell Reynolds.

What is to be done? The seminar,
which was held under the Chatham House
Rule, agreed that there is a problem, which
was put down to the specialised nature of
lawyers’ knowledge and general reluctance
to get involved with the business of their
clients. What boards needed was experience
in business and financial knowledge and
lawyers did not tick the boxes.

Edmund Burke famously said that:
“Law sharpens the mind by narrowing it.”
Although the lawyer’s analytical and
deconstructionist approach to a problem
may have its place in the boardroom these
are not the first skills the UK CEO thinks of
when putting his or her team together. After
all, lawyers can be hired when necessary.
So the first thing is for lawyers to take a
step away from the law and to broaden
their horizons.

Lawyers should start thinking about
this sooner rather than later in their careers.
The public and voluntary sectors might
be more prepared to take a chance on a
lawyer without board experience who was
committed to their aims, and this could
provide invaluable experience. Firms should
consider encouraging lawyers to take up
these non-commercial appointments.
They should not give rise to problems of
conflict of interest, and should result in
more business-minded lawyers. When it
came to applying for jobs they should think
about their CV in a different way, and be
prepared to be rejected often.

Vanessa Knapp, from Freshfields
Bruckhaus Deringer, who attended the
seminar said afterwards: “It was sobering
to hear some of the views about lawyers,
and there was also much food for thought.
Lawyers can offer an independence of mind
and ability to get to grips with a problem
quickly but may need to add more skills
before they can contribute fully.” David
Isaac said that, “Becoming a board member
of a charity can provide City solicitors
with very valuable skills and experience.
However, becoming a charity trustee should
not just be seen as a stepping stone to
joining the board of a plc. The experience
of helping to run a charity can be just as
rewarding as being involved in a plc.”

The world is run by boards, and lawyers
who want to play a part in running the
world will find they have to join one. Above
all you have to want it. As Antoine St
Exupery said: “If you want a man to build
a boat, do not send him out for wood and
nails, but teach him to yearn for the wide
and endless sea.”

Bill Knight retired as senior partner of
Simmons & Simmons in 2001. He is
now Chairman of the Financial Reporting
Review Panel, Deputy Chairman of
Council at Lloyd’s of London, a Gambling
Commissioner and Master of the City
Solicitors Company.
"IN 2006 BRITISH AMERICAN TOBACCO MADE PROFITS OF £2.6 BILLION AND PAID £716 MILLION IN CORPORATION TAXES. BUT NONE OF THAT WENT INTO THE TREASURY’S COFFERS BECAUSE BAT’S COMPARATIVELY SMALL BUSINESS IN THE UK LOST MONEY."

CLEANING UP CORPORATION TAX

By: Steve Coomber

THE INTERNATIONAL TAX SYSTEM NEEDS TO BE RE-INVENTED FOR THE TWENTY-FIRST CENTURY, SAYS MIKE DEVEREUX.
first, the newspapers were full of stories about office cleaners paying more tax than their private equity millionaire bosses; next the average tax payer in the UK was paying more than multinational corporations. It has not been a good couple of months for the tax system, where fairness is concerned.

In July 2007, the National Audit Office in the UK produced a report that, among other things, revealed that of the 700 businesses administered by the large business service in Her Majesty's Revenue and Customs (HMRC), about one third pay no corporation tax in the UK, while another third pay less than £10 million. In 2006, for example, British American Tobacco made profits of £2.6 billion and paid £716 million in corporation taxes. But none of that went into the Treasury's coffers because BAT's comparatively small business in the UK lost money.

The problem, says Mike Devereux, director of the Oxford University Centre for Business Taxation and Professor of Business Taxation at the Said Business School, is that the international tax system was created in the 1920s, in a different age; and not for a global economy where multinational corporations (MNCs), whose values in many cases exceed the Gross Domestic Product of nation states, span the world.

On the face of it, MNCs paying little or no corporation tax may seem unreasonable. However, it is understandable when you consider that the international tax system taxes companies depending on where their profits are made. Thus in the case of multinationals, HMRC collects taxes on profits made in the UK but not elsewhere. MNCs also pay tax on dividends paid to them by foreign companies they control, although in practice little revenue is raised from this, and even these dividends are likely to be tax free after proposed tax changes are implemented. Employing teams of clever tax advisors, MNCs have become adept at reducing their worldwide tax by maximising their ability to decide where they want to locate their taxable income.

“Where companies borrow is important, because interest payments are generally tax deductible. So if you have plants in Ireland and Germany, there is a big advantage to borrowing in Germany where you can save tax at 38 percent, compared to borrowing in Ireland where you save tax at 12.5 percent,” says Devereux.

Another way MNCs can choose where to locate their profits is through transfer pricing; shuffling profits around the world through intra corporation transactions, trying to park them in a country with a beneficial rate. Although the authorities try to prevent MNCs manipulating profits like this, it is not easy.

“Any transaction between two parts of an MNC has to have a price attached to it – supposedly an arm’s length price, as if the parties were not related,” says Devereux, “but this is difficult to do in practice, especially as the price would normally be determined by the market and may fluctuate accordingly.” So we have a tax system based on the conceptual idea that you can identify where profit is located, which, says Devereux, from an economic point of view, doesn’t really make any sense.

So is there a simpler, more efficient, more equitable way, suitable for the economic realities of the modern world we live in? Devereux believes there is. Before explaining what that is, though, it is worth asking the question: why should corporations pay tax? Ultimately, it is individuals that are worse off, whether it is employees via lower wages, consumers via higher prices, or shareholders via less shareholder value – these are individuals who are already taxed on income. In truth, it seems there is no obviously equitable justification for corporation tax.

Given that corporation tax is here to stay, however, why not make sure it is as equitable and efficient as possible. As an alternative tax system, Devereux proposes a destination-based tax. “A better option is to tax goods at the location where the final good is sold to the final consumer,” he says. “If adopted everywhere, such a tax could avoid existing distortions to the location of international investment, greatly reduce opportunities to shift profit between countries, and largely eliminate tax competition.”

We already have VAT after all. By taxing imports but not exports, VAT is effectively levied on a destination basis. A tax similar to VAT, but which gave relief for labour costs, would effectively create a destination-based tax on profit. Such a tax is much more difficult to avoid. It renders transfer pricing irrelevant, for example.

When the League of Nations devised the basic principles for an international tax system in the 1920s, it created a tax regime fit for the twentieth century. Is it not time we had a tax system fit for the twenty-first century? In the meantime, until someone takes the bold steps necessary to implement change, expect more lurid tax headlines. Who said taxation was dull?

Mike Devereux is director of the Oxford University Centre for Business Taxation and Professor of Business Taxation at the Said Business School.
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