

## Business

# There's more to business than money

THE boss of BP, Tony Hayward, said this weekend in public what many in business believe but precious few are prepared to live by.

He told the Sunday Times that there was "no industrial logic at all" in the mergers of large oil companies which were such a feature of the last decade – and indeed the defining feature of the stewardship of his predecessor Lord Browne. The oil industry needs access to new resources and access to new customers he says. Putting two existing businesses together achieves neither goal, and indeed size brings with it a whole range of new problems borne of complexity and remoteness. It is hard to believe that a smaller oil company would have been caught out, as BP was, by its problems of leaking pipelines in Alaska or the faulty procedures which led to the Texas refinery explosion, two events which have hugely undermined the progressive image of the company.

It is interesting too that the other big news of the weekend should be the Government's decision to try to bring more competition back into banking with the revival of Northern Rock, the spinning off of Scottish TSB business from Lloyds, and probably at some point the separation of the RBS-

Anthony Hilton



CITY COMMENT

branded banks from NatWest. It is easy to suggest that these measures have been forced on the parties by the EU competition authorities in Brussels, but we should be pleased, wherever the measures come from. Those who run big banks will often say in private – echoing Hayward – that there is no evidence at all for the idea that size brings greater efficiency. These measures are not much in the great scheme of things but at least they are a start, or will be some years from now when they actually happen.

But just as one is beginning to think people might at last be waking up to the often inherent wastefulness of corporate size, the same page of the same paper carries a report that the US processed food company Kraft is putting the final touches to a hostile bid for Cadbury the UK chocolate maker. The offer is expected to be launched once Kraft's latest profits figures are digested

by the market later this week. Yet this looks to be a deal entirely without merit, a merger of just the type which Hayward describes as pointless – pointless that is to everyone except the investment bankers and other advisers for whom it is the means to a fee-earning end. It is significant for example that in all the months of courtship which have led to this moment, no one has been able to come up with any sensible business reason for this deal, and neither has Kraft given any hint of an idea as to how it might improve Cadbury. It would be fair to assume that the reason for that is it cannot. This is about financial engineering – using the higher share ratings of the American market and taking advantage of sterling's weakness to buy the company when it is cheap, with the naked opportunism barely concealed by a fig leaf of notional cost savings which will no

**It is significant that in all the bidding Kraft still hasn't come up with any sensible reason to take over Cadbury**

doubt turn out to be a fiction, though not until thousands of jobs have been needlessly lost trying to deliver them.

Yet in spite of the "complete absence of industrial logic" the fund managers who hold Cadbury shares – those who have not already sold out to hedge funds – can scarcely conceal their eagerness to receive a bid. Because price is all that seems to matter to most of them they are more than likely to accept, not immediately but once it has been sweetened a bit to secure a recommendation of the board. Such is the usual course of the ritual dance which is about to follow.

Were the Cadbury shareholder base largely made up of private shareholders the company would be much more likely to maintain its independence because private shareholders identify much more closely with a company, its management, its products, its employees and its ethos. Institutional shareholders find such things to difficult and costly so ignore them.

People have tried off and on for years to see if there is some way such institutional shareholders could take into account a wider national interest but without success. Yet such a wider interest does exist. There was value to a city such as York, Norwich or Bristol –

where large local businesses have been sold to foreign owners – in having a headquarters in their town. The top employees supported the local infrastructure – schools, theatres, restaurants, transport and the like – and their loss after being taken over diminished these places.

Often they also diminish the tax revenue. One of the little discussed consequences of our willingness to sell all our businesses to foreign buyers is that the new owners usually arrange things – quite legally – to reduce to a minimum the tax they pay here. Over the years the likes of Rowntree (now Nestlé), Asda (now Wal-Mart) and the others have paid far less tax after takeover than they did when they were British-owned.

The financial meltdown has reminded us that there is a national interest in banks lending to small businesses even if it is not what they want to do. Perhaps we will one day similarly come to realise that allowing the future ownership of businesses to be decided exclusively by the self interest of fund managers does not always deliver the best results either.

Anthony Hilton's archive: [standard.co.uk/anthonyhilton](http://standard.co.uk/anthonyhilton)



## Derivatives are not weapons of mass destruction

After one expert on these pages argued \$600 trillion market is big threat, a top risk manager responds

IT IS very fashionable to malign derivatives for doing so much damage to the global economy. Politicians and the media have labelled them as Weapons of Mass Destruction which are responsible for massive corporate losses and the downfall of companies such as insurer AIG and Lehman Brothers. Some have gone so far as to suggest that derivatives are one of the major contributing factors to the credit crisis and the wider global recession.

However, to blame derivatives is like blaming a car for causing a crash, rather than the driver who was drunk behind the wheel. The cause of the global recession is manifold and the reason for many corporate failures is varied too.

AIG was perceived as being reasonably capitalised but had massively over-extended itself in trading a particular kind of derivatives, called Credit Default Swaps (CDS).

There is nothing wrong with the concept of trading risk, but it requires that the party who accepts this risk holds sufficient capital to honour its

### ANALYSIS

Bill Bartram

obligations in the event of a default. In particular, it requires an acute appreciation of the measurement of risk associated with different types of derivatives. This appreciation was clearly not possessed by the bank regulators nor, it would appear, by those politicians and journalists who continue to treat all derivatives the same.

Examples of where derivatives are used every day to great effect are all around us. As an example, over 50% of all government sponsored Private Finance Initiative (PFI) transactions incorporate inflation derivatives. These inflation derivatives help to provide your local NHS Primary Care Trust (PCT) with a known repayment schedule for their refurbishment works. The PCT can then more accurately plan additional investment in front line services. Similarly, any corporate entering into a major investment would

never consider leaving the bank loan supporting this expenditure unhedged, particularly at the current low level of interest rates.

The vast majority of derivative transactions, including the example above, are negotiated bilaterally. There are many voices who are currently calling for this trading – the OTC or "over-the-counter" market – to be heavily standardised, allowing for exchange-based trading. Unsurprisingly the exchanges themselves are lobbying hard for this, since they would stand to prosper immensely from hosting a \$600 trillion market! However, this is unlikely to be in the best interests of the wider financial system.

One of the unique characteristics of OTC derivative contracts is that they offer the ability for a counterparty to take security on underlying assets – rather than having to invest cash upfront.

If inflation derivatives were traded on an exchange, our PCT would have to post large amounts of cash with the

exchange to secure their inflation hedging. To give you an idea of the numbers involved, to hedge the inflation on a 30-year lease which currently pays rent of £1 million a year, the initial collateral required is likely to be somewhere between £2.25 million and £3 million. Costs such as these would probably be deemed prohibitive and the temptation would be to leave the risk unhedged. And as Shell and other major corporates have already testified, having to provide cash security for protecting their standard operating risks could greatly impact on their profitability. These kinds of cashflow events represent very real risks to a business, and will undoubtedly impact a company's decision as to whether or not it should make the capital investments required.

In the last fortnight, the EU has joined the fray and also has the OTC derivatives market in its cross-hairs. Their suggestion is that OTC trading should be discouraged and banks that engage in the OTC derivatives markets should

face higher capital charges. This idea cannot have come from anyone who understands the derivatives markets.

It must be understood that continuing flexibility in derivative structuring and application is paramount to effective risk management.

For this reason, where derivatives are being used to hedge risk the OTC market remains the most appropriate forum, and should not be penalised. Regulators should instead consider the relative risks involved for each derivative market.

The use of an exchange for derivatives where there is a high degree of risk, such as CDS, is quite pragmatic (assuming it can be made practical). This market is dominated by the banking and hedge fund sectors so the impact to the wider economy would be minimal.

The purpose of the financial markets should always be to support the wider economy. Demonising derivatives and making it harder, and more expensive, for companies to effectively manage their risks will only serve to hurt the economy at its very roots.

One easy step to reduce the systemic risks from derivative trading would be to change the accounting rules so that premiums paid (either cash or in the form of margin) for derivative instruments were spread out over their life. Unfortunately the value charged for the transfer of risk has been confused by the banking industry as profit, and paid out as bonuses.

The reality is that derivatives, when used properly, are a force for financial good and stability.

■ Bill Bartram is Head of Property Risk at JC Rathbone Associates



**Be afraid! A year after AIG, derivatives remain big risk**

ANALYSIS  
Satyajit Das

merical bets in financial markets where the total outstanding amount of derivatives adds up to a mere \$600 trillion

will argue for self-regulation, which is about as close to regulation as self-importance is to importance

**Debate: article in these pages on 12 October claimed regulators still do not properly regulate market**