

SECURITIES & INVESTMENT

# REVIEW

THE JOURNAL OF THE CHARTERED INSTITUTE FOR SECURITIES & INVESTMENT

CISI.ORG/SIREVIEW

DECEMBER 2015

## Up in smoke

How can the tobacco industry tackle the threat of e-cigarettes?

## Advice for all

How the Financial Advice Market Review can succeed

## Unmasking the clones

Spot the new fakers in finance

# Intelligent security

FORMER GCHQ DIRECTOR  
SIR DAVID OMAND ON THE  
CHANGING CYBER RISKS  
THAT FINANCE FACES

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Review of Financial  
Markets - see centre  
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**Editor**

Lawrence Cohen

**Consultant Editor**

Andrew Davis

**Art Director**

Steven Gibbon

**Account Director**

David Poulton

**Production Director**

John Faulkner

**Managing Director**

Claire Oldfield

**Chief Executive**

Martin MacConnol

**Advertising sales enquiries**

Deborah Maclaren

Telephone: +44 20 3004 7201

**Cover photograph**

Paul Tanner

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Chartered Institute for Securities & Investment  
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34–43 Russell Street, London WC2B 5HA  
Telephone: +44 20 7010 0999  
Fax: +44 20 7010 0900  
www.wardour.co.uk  
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**Chartered Institute  
for Securities & Investment**

Jane Playdon  
8 Eastcheap, London EC3M 1AE  
Telephone: +44 20 7645 0648  
Email: jane.playdon@cisi.org

**Editorial Panel**

Robert Merrifield, Chartered FCSI, <i>Chairman</i>	Sanford C Bernstein Habib Bank AG Zurich
Suren Chellappah FCSI	Chartered Institute for Securities & Investment
Professor Moorad Choudhry FCSI	Fidelity Worldwide Investment
Simon Culhane, Chartered FCSI	Deutsche Bank
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Jeremy Robinson, Chartered FCSI	Charles Stanley
Arijuna Sittampalam, Chartered MCSI	Sage & Hermes
Nigel Sydenham, Chartered FCSI	CCL Academy



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# The SPAC is back... and better than ever

## SPACs from the CISE

Special Purpose Acquisition Companies [SPACs] are growing again in popularity and the CISE has introduced rules which allow them to be listed on its leading, independent Exchange.

### Key features / benefits

The CISE's rules have been designed to provide a regime that is superior to others by being both commercially attractive for management teams and yet also offering robust integrity for investors.

The key benefits of the CISE rules for listing a SPAC:

- » **Low minimum market cap**
- » **36 month Qualifying Acquisition timeframe**
- » **Competitive fee regime**

Please visit our website or contact us for more information about our SPACs rules and to see how they may be applied to any particular set of circumstances.

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- » International marketplace
- » Globally recognisable clients
- » Growing product range

The Channel Islands Securities  
Exchange Limited  
Company registration number - 57524

**Registered Office**  
PO Box 623, Helvetia Court,  
Block B, 3rd Floor,  
Les Echelons, St Peter Port,  
Guernsey, GY1 1AR  
T: +44 (0) 1481 753000

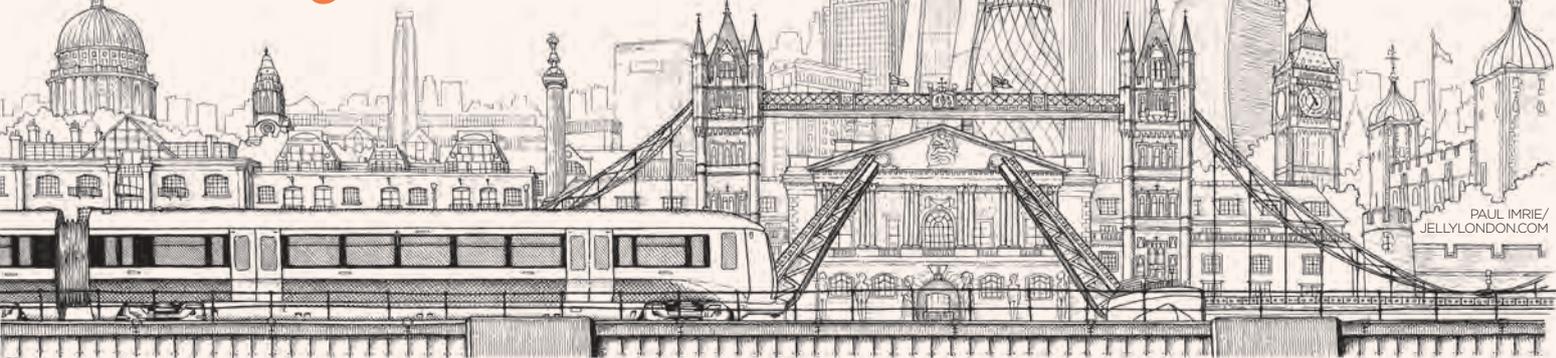
**Jersey Branch**  
No.3 The Forum,  
Grenville Street,  
St Helier,  
Jersey, JE4 4UF  
T: +44 (0) 1534 737151

follow @the\_cise  
follow us on LinkedIn

E: [info@thecise.com](mailto:info@thecise.com)  
[www.thecise.com](http://www.thecise.com)

**CISE**  
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# City view



## YOUNG MEETS OLD - THE CHANGING FACES OF FINANCIAL SERVICES AND WEALTH MANAGEMENT

Seven years after the worst of the financial crisis, young people are becoming increasingly aspirational about their futures, but risk being thwarted in their ambitions. Far from the traditional narrative of young people being underpaid and underwhelmed by financial matters, many are in fact quite aspirational, even principled, about their financial futures. At the other end of the spectrum, some well-established wealth managers have good cause to fear these youngsters in due course when it comes to keeping their mandates on inherited wealth.

That's the news from two brand new research studies, focusing on the young and the over-60s markets respectively: *Generation A: From austerity to aspiration* by Sophie Robson, and *Next generation* by research firm ComPeer.

Robson produced two previous reports that have led up to the latest one. She was a brainy young researcher at London's Centre for the Study of Financial Innovation, with which the CISI works closely, when she published *Generation Y: The (modern) world of personal finance* in 2012.

This ground-breaking report, based on extensive research and interviews with young people on their attitudes towards finance, shone a bright, fresh, well-informed – and non-condescending – light into this field.

She found, for instance, a lack of basic pensions knowledge among the 18-25-year-olds of Generation A, so called because they have lived most of their lives under the shadow of austerity. More significantly, nearly half those paying into a pension scheme

weren't even sure what type it was. That first report changed both private sector and government approaches to pension provision.

The CISI has long identified and met the need for better financial training from an early age to promote knowledge and confidence, and in the past year has had direct contact, through exams and other initiatives, with thousands of school students aged 14–19 in the UK. Last year, Robson, now at financial services consultancy MRM, followed up the 2012 report with one called *Generation austerity*, which rammmed home the need for that education and training from an early age.

### ComPeer's report makes worrying reading for many wealth managers

Her latest report, *Generation A: From austerity to aspiration*, suggests an encouraging uptick in mood among the young. It is based on a OnePoll survey of 1,000 18-25-year-olds, looking at their views on a range of topics, including advice and access, saving and spending, pensions and investing.

There is clearly a long way to go before most of their aspirations can be realised. Many are still priced out of the housing market, and wages and levels of employment have not really improved for this group since before 2008. Although one in three rated buying a property as their top priority, more than 40% said they didn't earn enough to save for a deposit. Similarly, while they recognised the importance of saving early for a pension,

43% didn't feel they were earning enough to justify contributing to one.

Meanwhile, ComPeer, long-established in wealth management, has interviewed 1,000 investors, ranging from the mass affluent to the high net worth. It announced the results to CISI members on 1 December, the day after *Generation austerity* appeared. ComPeer's *Next generation* report makes worrying reading for many wealth managers, with a client age of 60+ and services they believe match those needs. Their offerings may simply not meet the requirements of the next generation. Some firms fear, others hope, that inherited wealth will be transferred to a competitor.

Certainly, some wealth managers lack a coherent strategy for attracting and retaining the middle age group, the inheritors and those at the peak of their earning power. Most (but not all) have realised it needs more than adding a few apps to the current service proposition.

On the all-important bottom line, scalability – the flow-through of better revenues to even better profit margins – needs urgent attention in our industry. A ComPeer analysis of 127 firms' results over eight years shows that only four of them managed to achieve proper scale – higher percentage margins from higher revenues – in all eight years. That is a serious structural problem, and failure to meet changing client aspirations from both young and old will put a further strain on this crunch measure.

- Join in the discussion on both these reports live on *The longer view* on CISI TV at noon GMT on 14 December 2015. Register at [cisi.org](http://cisi.org)

# A year at the helm of the City and the CISI

When Alderman Alan Yarrow, Chartered FCSI(Hon), CISI Chairman and previous Lord Mayor of London took up the mayoral robes in November 2014, he said that the theme of his year as an ambassador for the City would be “six simple words: creating wealth, giving time, supporting people”



CISI colleagues and the Institute's mascot caught up with Alan as he arrived at Société Générale

“Creating wealth, giving time, supporting people.” Those words are very much a part of what the CISI, as a charitable institution dedicated to setting standards of professional excellence and integrity within the financial industry, is about. So, while Alan embraced that theme within his role of supporting and promoting the City as a world leader in international finance and business services, he also applied it to his role as CISI Chairman, signing memorandums of understanding (MoUs) around the globe to facilitate creating wealth and supporting people, and also giving his time to numerous charitable causes, including City Giving Day on 30 September.

He said: “I hope by being Lord Mayor that I have shone a light on the CISI and the terrific work it is doing in supporting people who work in financial services around the world. I am very proud to be the CISI's Chairman, and my objective this year was to improve the narrative so that people working in the City of London feel just as proud of working here as I do.”

Here we take a look at some of Alan's CISI-related highlights in his year at the helm of the City – a year that included over 100 days' travel to 30 countries.

## Global MoUs

Alan was in Kuwait in January for the signing of an MoU with the Kuwait Capital Markets Authority. This was to introduce Kuwaiti local regulations exams to

complement existing international technical qualifications offered by CISI and make them more locally relevant to accredited training partners in the region.

In February, he led a trade mission in Manila to strengthen UK-Philippines partnerships and promote UK financial and professional services. This resulted in the signing of an MoU between the CISI and the Philippines Securities and Exchange Commission, with the CISI agreeing to share its global expertise in the areas of continuous learning and qualifications training. The Institute will be opening a new office in Manila in January 2016, which will help to further its educational and charitable goals of improving financial literacy.

Also in February, the CISI signed a wide-ranging MoU with the National Bank of Kazakhstan – an institution the same size as the Bank of England – when the country's Prime Minister, Karim Massimov, visited Mansion House (Alan's mayoral residence). By the time President Nazarbayev arrived in London for a state visit in November, this had been developed into a full training programme inside the bank, embracing Islamic finance, securities and derivatives.

In May, Alan was in Colombo, Sri Lanka, where the Institute of Chartered Accountants of Sri Lanka signed an MoU with the CISI in order to promote the respective bodies' qualifications. That same month, Alan was present for the signing of an MoU with

HELP University in Malaysia to collaborate on providing training and coaching for candidates to achieve a globally recognised qualification in wealth management.

Then, in October, he witnessed the signing of an MoU between the CISI and the Chartered Institute of Bankers of Nigeria, agreeing to promote professionalism through qualifications, professional body membership and subscribing to a code of conduct.

## Giving time

Alan encouraged firms to get involved in City Giving Day as part of the Lord Mayor's Appeal charity on 30 September by making a donation, showcasing charity and community work, or staging a fundraising event. More than 200 firms participated, which, said Sarah Hinchley, Fundraising Manager for the Appeal, was a “fantastic response – our target was 100!”

Of course, the CISI pledged its support, and a representative went along to the breakfast event at the Guildhall at 8am. At lunchtime, 15 CISI staff went out with a griffin (the CISI's mascot) and a cardboard cut-out of Alan (the real one was busy on a whistle-stop tour of City institutions) to support the initiative by collecting for the Appeal. The Institute caught up with him as he arrived at Société Générale (pictured).

He said: “I was delighted that the CISI was involved in City Giving Day. It was a great success and gave a chance for those people who have received support to tell the story of how City firms have helped them in their time of need.”

## What's next?

Alan opened the Cambridge Economic Crime Symposium in September, the biggest event of its kind, with some 1,600 participants from around the world. In a speech, he acknowledged that cyber crime is a “major issue for our members and their firms” and spoke of the creation of a new taskforce that will bring together the financial services sector, law enforcement agencies and legal services in the tackling of fraud – something he is committed to supporting in his non-mayoral life as Chairman of the CISI.

# STANDING TALLER TOGETHER

Financial Planning | Operations | Capital Markets | Compliance | Risk | Corporate Finance | Wealth Management

We welcome the IFP  
community to the CISI.

Together we will work  
to benefit the consumer  
and the industry through  
qualifications and  
membership.



Professionalism

Integrity

Excellence

[cisi.org](http://cisi.org)

# The CISI and IFP complete merger: How it will benefit members

The CISI is delighted to announce that the merger between the CISI and the Institute of Financial Planning (IFP) was completed on 1 November and would like to take the opportunity to welcome all its new members to the community.

The merger follows the Institute's long recognition that CERTIFIED FINANCIAL PLANNER<sup>CM</sup> (CFP<sup>CM</sup>) professionals are at the pinnacle of the financial planning industry, with highly skilled practitioners operating from a deep knowledge base, demonstrating exemplary

standards of behaviour. These three attributes of skills, knowledge and behaviour are the powerful triumvirate that defines professionalism – and mirrors the standards we expect of all our members.

This is the start of an exciting chapter for all members. There will be no direct change to your membership level. However, you will benefit from the opportunity to access new financial planning resources and, as many of our members are moving into this market, we will now be able to provide you with better support.

## ACCESS TO A FINANCIAL PLANNING STUDY PATHWAY



One of our key priorities is to produce a new unit in the CISI's Investment Advice Diploma (IAD), that will both satisfy the

Financial Conduct Authority's requirements for advisers on retail investment products (when the full IAD is achieved) and cover the current content of the Principles of Financial Planning unit of the Certificate in Paraplanning.

Candidates passing the IAD with the Financial Planning unit will hold a Level 4 Retail Distribution Review-compliant qualification and will also have gained the Certificate in Paraplanning. Candidates who pass the Financial Planning unit as a stand-alone unit, and combine this with the CISI's Taxation in the UK for Individuals and Trusts, will gain the Certificate in Paraplanning.

New entrants are the lifeblood of the financial planning community and that's why we are keen to provide our members with a complete career pathway from within their professional body. We are making good progress: the draft syllabus for the Financial Planning unit is currently being reviewed by CFP<sup>CM</sup> professionals, and we are expecting to launch it early in the new year.

Members with the Certificate in Paraplanning are eligible to apply for Associate membership (ACSI), and members who attain the Level 6 Diploma in Financial Planning to become a CERTIFIED FINANCIAL PLANNER<sup>CM</sup> will be eligible to become full members (MCSI).



### New membership resources

Your CISI membership now encompasses new financial planning benefits, including the opportunity to receive *Financial Planner*

magazine, the monthly publication of the former IFP, attend financial planning continuing professional development (CPD) events and join the new IFP Professional Forum.

Members who join the IFP Professional Forum will receive *Financial Planner* as a benefit – it is currently only available to Forum members (all former IFP members are automatically part of the Forum) – with a view to expanding readership in the future.

The IFP Forum has been established from the merger between the IFP and the CISI. This group, run under the Chatham House Rule\*, provides the opportunity to network

with colleagues, listen to financial planning-focused presentations, engage in open discussion and share ideas and concerns in a confidential setting. The Forum will be chaired by members of the former IFP Board and will run at least six events a year. The Forum Committee consists of 11 professionals (nine of whom are CFP<sup>CM</sup> professionals) who were all Board members of the former IFP. The Committee's role is to support the CISI to grow the financial planning profession by way of planning forthcoming events, sourcing speakers and identifying areas of interest and future opportunities. The Forum will have a programme of events available from January.

This Forum is open to all CISI members – Chartered members, FCSI, MCSI, ACSI and Affiliate members, with programmes designed to meet the specific needs of your membership. Speakers at the Forum are all leading industry specialists, and all attendance hours are logged automatically if you use the CISI CPD scheme.

### Further information

If you would like to attend any future Professional Forum events, please call +44 20 7645 0777 or email [pf@cisi.org](mailto:pf@cisi.org)

\*When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed.

## An increased CPD event offering

Members can now benefit from financial planning CPD events, which can be booked at [cisi.org/events](http://cisi.org/events)

### UPCOMING EVENTS

#### 8 DECEMBER 2015

An update on trusts and their uses in Financial Planning (Isle of Wight)

#### 15 DECEMBER 2015

Principles of Financial Planning Exam Workshop (including principles e-learning) (London)

#### 14 JANUARY 2016

Monte Carlo or Bust? & Knowing your clients: How financial planning tools will build understanding and engagement (Tunbridge Wells)

#### 8 FEBRUARY 2016

The financial plan: A masterclass (Leeds)

#### 17 FEBRUARY 2016

Death benefits from pensions and nominations (Belfast)

#### 25-26 FEBRUARY 2016

Integrated Financial Planner Training Course (London)

This core Financial Planning skills training workshop runs over two days and provides attendees with a detailed understanding of the six-stage financial planning process. It is aimed at financial advisers, planners and paraplanners who wish to boost their financial planning skills so that they can provide an even better service that adds clear value for clients.

#### 9 MARCH 2016

Extracting value from a business tax efficiently (Belfast)

#### 14 MARCH 2016

Estate planning & IHT (Yorkshire)

#### 17 MARCH 2016

Advising on tax efficient investments: Due diligence and suitability & wowing by design (Tunbridge Wells)



## An expanded CISI branch network

The merger has enabled us to grow our regional branch network from 19 branches to 24, with the extra five branches located at: Cotswolds, Essex, Lancashire & Cumbria, Northern Home Counties, and Thames Valley.

Over time, as the CISI and IFP branches integrate, you will be automatically added to your local branch and continue to receive invitations to attend events in your area. The number of

events and seminars offered will increase, thus ensuring you benefit from both a wider range of relevant CPD and extensive networking opportunities.

For those branches that are merging, from April 2016 the IFP branch chairman will join the existing CISI branch committee. For those branches that will be new to the CISI, a new committee will be formed for each, which will come into effect on 1 April 2016.

## 60-SECOND INTERVIEW

*Chris Stears MCSI is Research Director at CCP Research Foundation CIC, a not-for-profit enterprise that goes beyond the balance sheet to research the risk of organisations that place public trust at the heart of their sustainability. He explains the motivation behind the research*



Chris Stears MCSI,  
Research Director  
at CCP Research  
Foundation CIC

### **So you are trying to measure trust?**

We are engaged in the search for reliable metrics for evaluating (and predicting) an organisation's culture and conduct record. One such metric is a firm's conduct costs, and this is the focus of the foundation's

flagship project. This project has created a proprietary dataset evidencing the financial consequences of bank misconduct through the prism of conduct costs – principally fines and recompenses.

### **How does the financial world benefit?**

Our methodology and data could form part of a wider framework of accountability. Beyond this 'cultural' indicator, of course, are the risk management benefits from the data. When leveraged with a firm's internal metrics, the project's data presents the opportunity to defend its conduct risk

management, culture and, potentially, its regulatory capital requirements.

### **How much information do you hold, and who uses it?**

The data covers 16 major international financial institutions and runs to more than 1,000 separate entries. The high-level results are published online with the detailed underlying data available to members of The Conduct Costs Projects Association.

The data has been used by the Bank of England, HM Treasury, the Financial Conduct Authority, and the European Systemic Risk Board. It has also been cited in academic journals and online publications, the *Financial Times* and other media.

### **Hard work, but worth it?**

As the Fair and Effective Markets Review said: "The work of ... the CCP Research Foundation ... could provide a framework for further development in relation to industry-wide performance measures relating to conduct." This project has been most

valuable to my professional engagements, providing the opportunity to influence policy makers, regulators and banks striving to respond to the crisis of trust.

It has been a privilege to be involved at the coalface of the integrity debate – a debate that, I am pleased to say, has extended beyond the banking fraternity.

And, of course, the lessons for conduct risk management are equally germane to the sustainability of CISI members' relationships with their own stakeholders.

- Meet Chris in January when he and his colleagues will be discussing conduct costs with CISI members and introducing, for debate, various initiatives aimed at furthering the 'professionalisation of financial services' agenda. Chris and colleagues will also be discussing what it means to acquire and maintain, as BoE Governor Mark Carney has put it, the "social licence to operate". See [cisi.org/courses](http://cisi.org/courses)

## The knowledge: Presentation tips

**Effective presentation skills are invaluable in business. Julia Kirkland, Chartered MCSI, Managing Partner at Financial Services Training Partners, gives five handy hints to help you get your message across.**

### **1 What is the purpose?**

Consider your audience, give thought to why they are there and what they want to hear. Make it clear at the outset what you are going to do and follow your plan. Remember the 'what's in it for me' (WIIFM) principle – the audience does not want this to be a waste of its time.

### **2 Tell a story**

Having a story or theme running through your presentation will make people remember what you have said. You may be there to 'sell' them something or to

give them some important information. Telling them stories – delivered with humour and 'Ah ha!' moments – that explain how you have helped others and how that could benefit them will make it more memorable.

### **3 Give a performance**

You don't have to be Judi Dench or Billy Connolly, but no one enjoys listening to someone drone on in monotone. Think about the use of inflection, pace and use of pauses. If you are able to memorise your script, then great, but that requires practice. Remember, the slicker, the better.

### **4 Use of media**

PowerPoint, visuals and handouts can be effective presentation tools, but only when used correctly. Try not to

put too much on slides – the audience might feel they could just as easily read the presentation. Focus instead on storytelling and performance.

### **5 Leave them motivated to take action**

The best presentations lead to action, even if that is only posing questions that make the audience leave with a sense of purpose to change what they are doing. Your ideal world would be a queue of people wanting to discuss your presentation and ask questions about how it can make a difference to them.

### **Further information**

For a full list of CPD training courses, visit [cisi.org/courses](http://cisi.org/courses)



## Ask the experts: How to value a fintech start-up

### **There are many different types of fintech start-up. Which is the best type to invest in?**

Many argue that investors should seek only unicorns – those venture capitalist-backed investments that can deliver extraordinary returns – and look for those 20 times to 100 times returns that they have the potential to deliver. However, there are at least two problems with this approach. First, no one really knows ahead of time which start-up will be the ‘greatest ever’. Second, with a lot of people chasing the same deals for fear of missing out, valuations move into bubble territory, and extraordinary returns suddenly don’t look so likely.

At the other end of the spectrum are firms and individuals that invest in hundreds of start-ups at seed stage and hope for the best.

### **So what should investors look for in a fintech start-up? Which types are more likely to deliver a healthy return?**

The key is to take a more systematic approach. Look for those start-ups that you think have the potential to significantly influence the industry. Such a company is likely to have a high value in the future and generate good returns for investors that invest at reasonable valuations. The best immediate candidates are start-ups

that develop technologies that are aligned with what banks do today in terms of their strategies, business and IT.

Start-ups that get a lot of attention are those that compete with banks and are sometimes called ‘disruptors’. I believe that those companies will be able to arbitrage the execution speed and clarity of vision between themselves and incumbent financial services institutions – for a while, at least.

More interesting are start-ups that develop new or complementary products or services. Banks and other financial services firms might not enter into a commercial relationship with such a start-up for now, so it will need to go to customers directly, sell to retailers and find other ways to grow until it becomes obvious that what it is offering is a good idea.

It is in this unproven, untested and strategically misaligned start-up that I see a lot of potential for extraordinary returns for fintech investors. It is also where I look for a significant ‘tech’ component of fintech – otherwise, the idea is quickly copied once it becomes clear that it works.

### **Are there higher-risk fintech start-ups that investors should consider?**

The dangerous one is the visionary, revolutionary, futuristic start-up. I would not

ignore these companies, but investors should be particularly careful when deciding how much to invest in this type of start-up.

However, I like the idea of a fintech start-up testing new concepts in fail-fast mode to learn ‘by doing’. And although you have to accept that such a company may not benefit an incumbent financial services institution for a while, it is worth staying close to those with potential to change things dramatically.

The tech component, though, needs to be even stronger in these start-ups. It must be aligned with the trends we see taking shape, such as mobile, cloud, social, automation, crypto, cyber security, big data and predictive learning.

### **So investors should take both a short-term and long-term view of fintech start-ups?**

Yes. The horizons I look at are now, the next two years and the next five years, rather than constantly looking for the next ‘overnight success’.



Mircea Mihaescu,  
General Partner,  
SBT Venture Capital

## The S&IR wins integrated media award



S&IR Editorial Panel Chairman Robert Merrifield (centre) with the team behind the journal

The *Securities & Investment Review* (S&IR) won the Integrated Media category at the Institute of Internal Communication (IoIC) Awards 2015.

The S&IR beat publications produced for the likes of Barclays, the Post Office and RBS to the award.

The journal was also shortlisted for best feature-led magazine (up to four times a year) and received an Award of Excellence at September’s IoIC Awards ceremony, held at London’s Park Plaza in recognition of “the best internal communicators from across the UK”.

Our success in this year’s awards comes after the CISI, with the help of the S&IR Editorial Panel and publishing partner Wardour, launched a digital edition of the journal last year to complement the print edition. The digital edition has allowed the Institute to publish news and features on the financial services sector on a daily

basis, while the print edition has continued to deliver the more in-depth, reflective articles that members have long valued and enjoyed.

Content from the print edition is now repurposed for the digital edition, making features – such as interviews this year with Sir Gerry Grimstone MCSI, Chairman of Standard Life and Dame Collette Bowe, Chairman of the Banking Standards Board – available to the Institute’s 40,000 members worldwide.

Thank you to everyone who has read or contributed to the S&IR this year, and we look forward to developing the journal further across our print and digital channels in 2016.

# BACK STORY

*Stephanie Barnett, Chartered MCSI, Training & Competence Manager, Vestra Wealth*



Careers in financial services are often shaped by economic events – just ask Stephanie Barnett. Her first job was as an insurance underwriter for the Prudential at its Southend office in Essex, and, although determined to build a career in finance, she had no initial plans to become a trainer.

In the early 1980s, she transferred to Prudential's London office. During her time there, two significant UK Government decisions propelled Stephanie towards a career in training. First was the 'Big Bang' in 1986. "That was the genesis of compliance as we understand it today," she reflects. Second was the introduction of the Personal Equity Plan three years later, which led to Prudential creating a separate entity for PEPs.

"We were getting errors creeping in because there were very few people there who understood the cradle-to-grave process," she recalls. "I was in a meeting one day and said, 'What we need to do is train colleagues'. The response was: 'Great idea! Why don't you do it?' So I did." Stephanie later helped write the Investment Management Regulatory Organisation's Training and Competence (T&C) rules. And when Prudential acquired M&G in 1999, she took over T&C for the entire firm.

“My role is to help people be as good as they can be”

But her career took a dramatic turn in 2004, when her husband was made redundant and she moved to Spain to run a restaurant. Not everything, however, went to

plan: "I taught myself Spanish, but I taught myself Castilian and found when I got there they spoke Valencian. Fortunately it's a bit more like French, so I was able to find my way through." Surviving the experience meant the City held no fears for her when she returned two years later as a trainer for Cofunds. She then worked at Smith & Williamson and Barclays before joining Vestra Wealth in June this year. Throughout that time, she has coached people through their professional exams. "When someone's failed something four times and you work with them and they pass, that's really satisfying," she says.

Helping others is something she enjoys: "My role is to help people be as good as they can be. I don't think it's about ticking boxes. I try really hard never to say the phrases 'regulator', 'FCA [Financial Conduct Authority]' and 'training and competence'. I only ever talk about commerciality. Before I retire, it's my mission to eradicate the term 'training and competence'." She delivered this message when she chaired the CISI Training & Competence Conference 2015.

Outside work, Stephanie enjoys everything from dancing and travelling to cooking: "The schools have not done a good job of teaching people to cook. When I retire, I'd like to go to people's houses and help them learn, which will allow me to continue to deploy my coaching skills."

- If you would like to tell us your own back story, email [gareth.francis@wardour.co.uk](mailto:gareth.francis@wardour.co.uk)

## Events preview

The CISI offers plenty of opportunities to help you meet your requirements for professional development. Below are just some of the highlights of the Institute's events programme. For further information, take a look at [cisi.org/events](http://cisi.org/events)

### A FOCUS ON LONDON CPD EVENTS

January's programme includes: a review of the investment outlook for next year, on the morning of 22 January 2016 at Grant Thornton in Finsbury Square; a dissection of tax efficient products in the new heavily restricted environment, at Mazars by Tower Bridge on 14 January; and on 8 February, a special look at FIFA, asking the key question: where were the money laundering controls in this biggest of scandals?

### CONFERENCES & CPD WORKSHOPS 14 MARCH 2016

#### FINANCIAL PLANNING: ETHICS CPD WORKSHOP

America Square Conference Centre, 1 America Square, 17 Crosswall, London, EC3N 2LB

### ANNUAL DINNERS

**5 FEBRUARY 2016** Guernsey Annual Dinner

**25 FEBRUARY 2016** Northern Ireland Annual Dinner

**11 MARCH 2016** Jersey Annual Dinner

### OTHER HIGHLIGHTS INCLUDE:

- 13 Jan 16: Wealth Management Professional Forum: Smart beta strategies
- 14 Jan 2016: Knowing your clients: How financial planning tools will build understanding and engagement (South East)
- 14 Jan 2016: Vulnerable customers (Wales)
- 19 Jan 2016: Oil, gold & the US dollar: Will recent commodity corrections lure investors? (Isle of Man)
- 20 Jan 2016: The role of the new CI Ombudsman (Guernsey)
- 21 Jan 2016: Training and competence under the new conduct rules and certification regime
- 21 Jan 2016: Behaviour economics: Bulls and bears – are we all sheep? (Liverpool, Chester & North Wales)
- 26 Jan 2016: Bond Professional Forum: Bond markets – the year ahead
- 26 Jan 2016: Oil, gold & the US dollar: Will recent commodity corrections lure investors? (Yorkshire)
- 2 Feb 2016: How to use LinkedIn as a business development & lead generation tool
- 4 Feb 2016: MiFID II (Liverpool, Chester & North Wales)
- 8 Feb 2016: The financial plan: A masterclass (Yorkshire)
- 12 Feb 2016: Behavioural finance (West Country)
- 18 Feb 2016: Ethical investing (Guernsey)
- 23 Feb 2016: Introduction to financial markets
- 23 Feb 2016: What can we learn from the mutual flow funds

- For details of conferences, training courses, CPD and social events available to members, visit [cisi.org/events](http://cisi.org/events)

## CISI Membership Privileges

### Special deals on shopping vouchers for CISI members

Have you been after a new winter coat, or work clothes for the colder months? Now is the perfect time to take advantage of a range of shopping vouchers on the CISI members' website and save on a new winter wardrobe.

Browse retail vouchers at your favourite brands, such as '9% off' e-vouchers at House of Fraser. These will be sent to your email address, and you can then benefit from using them both in store and online.

The flexibility of the House of Fraser e-vouchers means you can

combine the discount with sales available at the time, which can include women's, men's and kids' fashion, beauty, homeware and more, making shopping easy.

For more information and to view the range of retail vouchers, log in to the MyCISI area of the CISI website, go to My Benefits, click on View your Membership Privileges, and start browsing.

\*Terms and conditions apply. See website for further details.



The *S&I*'s quick quiz features questions from CISI Professional Refresher, an online learning tool. This popular product consists of more than 65 modules covering topics including anti-money laundering, the UK Bribery Act, information security and data protection. The answers are on page 15.

**1. Which of the following is not one of the main elements of the package of measures being introduced by the Financial Conduct Authority and the Prudential Regulation Authority?**

- A Conduct Rules
- B Approved Persons Regime
- C Senior Managers Regime
- D Certification Regime

**2. Purchasing a convertible bond and selling short the underlying equity is a strategy known as:**

- A Convergence
- B Arbitrage
- C Strategising
- D Hedging

**3. The Senior Managers and Certification Regime implements recommendations initially made by which body?**

- A Parliamentary Commission on Banking Standards
- B Financial Conduct Authority
- C Prudential Regulation Authority
- D Financial Policy Committee

**4. How long must a transaction be delayed if the National Crime Agency refuses consent upon receiving a report of a suspicion of money laundering?**

- A 5 days
- B 7 days
- C 15 days
- D 31 days

## Review of Financial Markets (RoFM)



This edition of the *S&I* contains in its centre pages the eighth issue of the CISI's academic journal, *Review of Financial Markets (RoFM)*

The 12-page publication includes diverse papers from academics based around the world.

*RoFM* Editor Moorad Choudhry FCSI (pictured), CEO at Habib Bank AG Zurich, says farewell

to the readers in his editorial on the front page, following his announcement in the previous edition that this will be the last one he works on.

The CISI would like to thank him for his invaluable contribution to *RoFM* since it launched in March 2014, and wishes him all the best in the future.

## Check out our digital edition

Keep up to date on developments through the digital edition of the award-winning (see p11) *Securities & Investment Review*



CISI members worldwide can log in using their tablets or smartphones and read news and features on the issues that matter to them.

- View the digital edition at [cisi.org/sireview](http://cisi.org/sireview)

Access to Professional Refresher is available on an annual licence basis. The full suite of modules is free to CISI members or £250 for non-members. If you or your firm would like to find out more about Professional Refresher, visit [cisi.org/refresher](http://cisi.org/refresher) or contact the CISI on +44 20 7645 0777.

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# Back to the future

A NEW THESIS HAS SHED LIGHT ON WHY MUCH OF THE WESTERN WORLD IS SEEING LITTLE GROWTH IN INCOME OR YIELD

✦ ANTHONY HILTON ✦ JOHANNA WARD

**F**or the past decade, the vast majority of people in the UK have seen no growth in their real incomes. It is the same story across Europe and, surprisingly, even in middle-class America. You have to go back to the Great Depression of the 1930s and beyond to find anything like it. Not since the Victorian era has so little been earned by so many for so long.

It is not just incomes; investors and savers are suffering too. Andy Haldane, Chief Economist at the Bank of England (BoE), made a speech a few months ago in which he pointed out that official interest rates today are lower than they have been at any time since the BoE's formation more than 300 years ago. Indeed, he went on to suggest – admittedly tongue in cheek – that our rates today are probably the lowest they have been for 10,000 years.

Low interest rates on savings feed directly into low returns on almost every other investment too. The search for yield has become the defining mantra of our times. And yet global growth has all but disappeared. Since 2008, the Chinese locomotive has been the only game in town. Now that it is slowing, what will pull the world along?

This is a totally different economic world from that which existed from 1945 to the millennium. But we know that. What we don't know is: why? What is lacking is an explanation as to how this has happened. We are living through the biggest shift in the economic weather any of us have seen in a lifetime and yet, other than assuming it is an unfortunate consequence of the global financial crisis, no one knows where it has come from.

At least, not until economist Charles Goodhart and a team at Morgan Stanley came along earlier this autumn. They say it is all about demographics.

Their thesis is that since about 1970, when baby boomers entered the labour force for the first time, there has been a massive and sustained increase in the number of workers in the industrially connected world. It began with the boomers. Then it received a further boost in the 1990s with the collapse of communism and the subsequent integration of Eastern Europe and Russia into the world economy. Then it received an even bigger boost when China arrived on the scene. These three factors together virtually doubled the globalised labour pool.

Now, when the supply of something doubles, the price drops, and that is what happened. Wages around the world fell or at best stagnated. But it did not stop there. Because labour was so cheap, other prices had to adjust too. It made sense to employ extra people rather than to buy labour-saving machinery. Companies preferred to outsource to Asia rather than build a new factory in the West. Investment fell around the world.

But that then left us with too much saving – huge pools of money built up without investment to finance. And because there was a savings glut, the price of money also fell – hence the low interest rates. All the key economic variables in the world have had to adjust to the sudden fall in the price of labour. And this is what we now call the new normal. Get used to it.

Or perhaps not. The most fascinating part of the analysis is still to come. The population of the developed world is rapidly ageing, and because birth rates have been falling for years, labour is about to become scarce again. The pendulum is about to swing back, because the number of young people coming into work is insufficient to replace the number retiring.

This is already happening in Japan and, as it gathers pace elsewhere, including China, wages will have to rise. That will increase spending power, push up demand and encourage companies to invest. More investment means an increased demand for savings, which will in turn push up the cost of money. Higher interest rates will lead to higher investment returns across the board. Gradually, over the next decade, higher real incomes will feed through into everything else, the processes of the last 30 years will reverse and the world will come once again to resemble that which we used to know.

So there you have it. Just as we have got used to the new normal, the old normal will be back to bite us.

**Anthony Hilton is the award-winning former City Editor of *The Times* and the *London Evening Standard***



# Unmasking the clones

THE THREAT FROM FRAUDSTERS POSING AS REGULATED FINANCIAL SERVICES COMPANIES IS ON THE RISE. HOW CAN CONSUMERS ENSURE THAT THE FIRMS OR INDIVIDUALS THEY ARE DEALING WITH ARE THE REAL THING?

✦ JILL INSLEY ✦ TOM SYDENHAM

The Financial Conduct Authority (FCA) has issued 78 warnings so far this year to protect consumers from an increasingly common and insidious type of fraud: cloning.

But this is just the tip of the iceberg. Action Fraud, the UK's national fraud and internet crime reporting centre, received 8,821 reports of investment fraud, including clones, in the year ending March 2015 – an increase of nearly 2,000 on the previous year. The National Fraud Intelligence Bureau (NFIB), meanwhile, calculates that each City of London boiler room is making an average of £1.25m.

Jon Avers, City of London Corporation Public Protection Director with responsibility for Trading Standards, says: “Consumers, who are often elderly and vulnerable, are actively targeted by these scammers, and persuaded to trust them and transfer very large sums – typically over £50,000 – in the hope of gaining a little more income from savings.”

Cloning scams are very much like traditional boiler room scams. Fraudsters from clone firms cold call potential investors to promote shares, property, wine or other types of assets that are either worthless, overpriced, non-existent or impossible to trade. But those involved in cloning take the idea even further by convincing potential victims that they are members of staff calling from genuine firms authorised by the FCA.

The fraudsters call using a name, address and FCA firm registration number that is very similar or identical to that of the genuine firm. Those that have been targeted by this type of scam include BlackRock, Invesco Perpetual and Henderson Global Investors.

The scammers provide their own telephone numbers and website addresses to potential victims. Then, when the paperwork is sent out, the documents contain details of a very

similar sounding company set up to deliberately defraud investors.

The FCA says that fraudsters sometimes try, unsuccessfully, to change genuine firms' contact details on the Financial Services Register – a public record of firms, individuals and other bodies regulated by the Prudential Regulation Authority (PRA) and/or FCA – to their own, or claim that a firm's contact details are out of date. “This is unlikely as we update the register each evening,” says the FCA. Alternatively, the scammers may claim to be from overseas firms listed on the register, as these firms do not always have their full contact and website details listed.

## WARNING SIGNS

It is easy to see why victims are taken in. On 14 October this year, the FCA posted a warning about a clone firm calling itself HH Hubwise Holdings, which purported to provide “fully managed FX accounts of the highest standard”. The firm gave its address as Ascension House, Burton-on-Trent, DE14 2WW – identical to that of the genuine company that it had cloned: the FCA-registered Hubwise Securities. The clone firm's website was totally convincing.

*“Advisers entice customers to invest in coffee plantations, renewable energy and other such products”*

Fraudsters also clone authorised individuals. In August this year, the FCA warned the public about a fraudster purporting to be Yvonne Smith from Henderson Global Trading (a non-authorised firm with no relationship to the genuine Henderson Global Investors). She had cloned the details of the real Yvonne Smith, Director of Property & Asset Management at Helix Property Advisors.

Many of the fraudsters are out of reach of UK regulators and police. Nikhil Manek, Senior Manager KPMG Forensic, says there is a worrying trend of fraudsters from across mainland Europe. “These advisers have targeted the British expatriate community and entice customers to invest in coffee plantations, renewable energy and other such products,” he says.

There is little chance of victims getting their money back. Although some realise almost immediately that they have fallen prey to a scam and contact their banks to see if they can retrieve their money, it is virtually impossible for banks to help them.

Adrian Leppard, Commissioner of City of London Police, the UK police force that leads on economic crime and runs both the NFIB and Action Fraud, says: “There is evidence to show they are using increasingly complex money laundering methods to disperse money belonging to a victim in minutes.”

In the unlikely event that money is still sitting in the fraudster's account, the bank can prevent its removal. But dispersal of such money is determined by the Clayton's Case rule on a ‘first in, first out’ basis. Unless your money was the last payment into the account, you are unlikely to get a refund.

As clone firms are not authorised by the FCA, they are not covered by either the Financial Ombudsman Service or the Financial Services Compensation Scheme, which means there is no hope of compensation from either body.

## PREVENTION AND CURE

City of London Police has been working with the banking sector, the National Crime Agency and the Home Office to develop a joint taskforce to look at how this type of crime can be prevented and illicit payments stopped. Leppard says: “We already share information on money laundering cases with the banks in order to prevent crime and to identify potential criminal networks, and ✦”



## SPOTTING A CLONE

It is highly unusual for a legitimate investment firm to cold call potential investors, and receiving such a call out of the blue should set alarm bells ringing. The caller may try to persuade their target that this is not a cold call by referring to a brochure or email that has been sent to them.

The investment will sound fabulous. The fraudsters will also try to downplay the risk to the potential investor's money. They may discuss how their target will own actual assets they can sell if the investment doesn't work as expected, or may use a lot of jargon to convince them the investment is safe.

They are also likely to use high-pressure tactics, such as claiming that the investment they are promoting is only available for a limited period, or offering them a bonus or discount if they invest before a certain date. The potential investor may be asked not to tell anyone else about the investment opportunity they are being offered. They may receive calls, with the scammer staying on the phone for a long time.

Whatever the approach, the best course of action for anyone who receives such calls is to hang up.

The FCA "strongly advises" investors to deal only with firms that it authorises, and says that individuals should check the Financial Services Register at [fca.org.uk/register](http://fca.org.uk/register) to ensure that a firm is authorised.

The register should be accessed via the FCA website rather than a link provided by the investment firm in an email or on its own website.

To verify the identity of an authorised firm, investors should ask for its firm reference number (FRN) and contact details, but should always call the firm back on the switchboard number given on the Financial Services Register. If there are no contact details on the register or the firm claims they are out of date, the FCA's Consumer Helpline should be contacted on **0800 111 6768**.

Unfortunately, today's fraudsters are highly adaptable, and as one scam is revealed and closed down, they move on to the next. Concerned investors can keep up to date with the latest scams by looking at the scams section of the FCA website at [fca.org.uk/consumers/scams](http://fca.org.uk/consumers/scams), and can see investments that have been offered on the FCA Warning List at [scamsmart.fca.org.uk/warninglist](http://scamsmart.fca.org.uk/warninglist)

are keen to do more with our partners in Europe as well."

However, he believes the key to prevention is making sure the public is properly informed about fraud. "Every officer in this country can give useful advice to members of their community on how to prevent a burglary. Can the same be said with regards to more modern offending?" he asks.

To ensure police officers are able to provide such advice, City of London Police has developed a 'prevention hub' that shares information with other police forces so they can understand and pass information on to the public.

Earlier this year, City of London Police, Trading Standards and Metropolitan Police visited a number of offices in the Square Mile, Canary Wharf and Westminster as part of a co-ordinated, intelligence-led drive to uncover suspected boiler rooms and inform the virtual and serviced office providers that they were unknowingly providing criminals with prestige addresses from which to promote their scams. They also distributed flyers outside London transport hubs and warned workers of the consequences of being part of a criminal operation that cold calls people in the UK with bogus investment opportunities.

Members of the public, meanwhile, can check their adviser's details on the Financial Services Register. But from March 2016, bank employees, including financial advisers, will no longer be listed on the register. Instead, employers must certify their staff members themselves. This change is likely to be extended in the future to employees of wealth management and investment firms.

## CHECKING OUT

The move may seem to be counter to the desire to ensure investors are properly informed and able to protect themselves from fraud. But a spokesman for the FCA says the regulator does not believe certification will make life easier for fraudsters. In fact, it could make stealing the details of staff members harder, because of the shift in responsibility to the banks for ensuring their staff are 'fit and proper'.

It is still essential, however, to use the FCA's various resources to check whether firms are who they say they are (see box above). With the threat from fraudsters on the rise, a little checking can go a long way to ensuring investments don't fall into the wrong hands.



A full-page photograph of Sir David Omand, a man with short grey hair and glasses, wearing a dark grey suit, a light blue shirt, and a colorful patterned tie. He is standing with his hands resting on a dark wooden ledge in front of a large window with a grid pattern. The lighting is soft, coming from the window behind him.

# Strong defence

AS FORMER DIRECTOR OF GCHQ, SIR DAVID OMAND IS A GLOBAL SECURITY GURU. WITH THE CRIMINAL THREAT FEATURING SO HIGHLY ON THE AGENDA OF MOST FINANCIAL BOARDS, HE EXPLAINS WHERE THE DANGERS LIE AND WHY WE MUST ESTABLISH A NEW 'SOCIAL COMPACT' TO BALANCE PRIVACY AND SECURITY

 GEORGE LITTLEJOHN  PAUL TANNER

Sir David Omand recalls the legend that grew up around the great American blues player Robert Johnson. “It is said that as a young man, he had gone to the crossroads at midnight and sold his soul to the devil in return for the gift of playing the blues as never before. And one night, of course, as his song says, the devil came calling.

“We should remember,” warns Sir David, “that we rushed to sell our souls to the inherently insecure internet in return for the easy advantages it offered: savings in staff costs; direct interaction with customers; targeted marketing; profits from global trading. Now the devil has come calling for us in the shape of cyber attacks.”

Sir David’s career has been all about ‘securing the state’ – the title of his latest book, which has won international plaudits. He is a private man, with a love of family, music and the mountains of his native Scotland. Possessing a ferocious intellect, Sir David is a Cambridge economics graduate who also has a first-class degree in mathematics and theoretical physics from the Open University, achieved after his retirement from the civil service. In business, he is a senior independent director of a FTSE 100 company.

“I started my career in 1969 in the intelligence world when I left Cambridge University and joined GCHQ, the UK’s signals intelligence [and today, also its cyber

security] department. I occupied much of my subsequent time in government service worrying about the defence issues of the Cold War, including nuclear deterrence strategy, faced as we were with the existential national security challenge of Soviet communism.

“My last job was as UK Security and Intelligence Co-ordinator in the Cabinet Office, crafting the British counter-terrorism strategy, CONTEST, after 9/11.

*“Companies have to keep business networks separate from control systems”*

“The contrast between these worlds could not be more stark. Nevertheless, today the potential for interstate tensions and conflict has not disappeared; it has just taken different forms. In Europe we have, for example, imposed sanctions on Russia because of its aggressive disregard for international law in the Ukraine. Russia has now intervened directly in the already complex Syrian conflict, greatly complicating Western strategy.

“The concept of advancing national interests through hybrid warfare and cyber warfare is changing the rules of war and causing governments to rethink how they can deal better with the non-military aspects. Nations can, for example, protect and hide behind proxy terror groups and cyber criminal gangs to cause difficulties for nations they see as their adversaries.

“In the UK we are highly vulnerable to such attacks. It took only a few years for the internet to become irreversibly enmeshed into our financial life and for the criminals to latch on.

“Ivan Turchynov and Oleksandr Ieremenko, for instance, and their gang are on trial in the US for hacking into newswire services to get hold of advance copies of market-sensitive press releases from companies such as Boeing, Hewlett-Packard and Oracle before their release to the market. It is classic insider dealing, but through cyber attack, that it is claimed netted them \$100m before the Securities and Exchange Commission caught up with them.”

#### DEFENDING BIG DATA

The internet is a network of individual networks that store almost unimaginable volumes of data that can be accessed online. That includes sensitive personal data that

can be identified and used for good, or for criminal gain, such as, says Sir David, “the 385 million stolen email addresses used by Yvgeny Bogachev and his Russian cyber criminal gang to spread the Dridex banking trojan malware, through the botnets they controlled, aiming especially at UK-based banks. At its peak last November, the Dridex campaign distributed up to 15,000 documents with malicious macros every day, posing as invoices from software companies, online retailers, banking institutions and shipping companies.”

The UK, along with every advanced economy, is dependent on the effective functioning of the internet in three ways, says Sir David: “On the functioning of the web to keep normal life going; on the security of control systems connected to it; and on the availability and integrity of data stored.

“A simple example of the first category is the denial-of-service attack on RBS at the end of July this year, that prevented customers logging on just as their pay cheques were reaching their accounts. An easy attack to mount – and yes, the website was fixed an hour later, but reputation still suffers.

“A good example of the control systems problem was the recent report by Germany’s Federal Office for Information Security of a cyber attack on a German steel mill, where the company network was penetrated and malware inserted that prevented a blast furnace being shut down, causing massive damage. No one has claimed responsibility for this attack, but it is an example of the type of attack we must expect from future asymmetric warfare against our infrastructure control systems, for example as payback if we impose new financial sanctions. It also shows how careful companies have to be to keep business networks separate from control systems.”

As far as integrity of data goes, according to the US Director of National Intelligence, James Clapper, the next push on the envelope is going to be the manipulation or the deletion of data that would compromise its integrity. This is added to the risk of data theft, such as the recent massive loss of US federal employee data, including the details of all employees who had been security vetted: hugely valuable to those conducting counter-espionage.

#### THE RISKS TO FINANCE

“Attacks on the financial system are becoming more sophisticated,” Sir David

## THE CV

**CURRENT** COMMISSIONER FOR THE GLOBAL COMMISSION ON INTERNET GOVERNANCE AND VISITING PROFESSOR IN THE WAR STUDIES DEPARTMENT AT KING’S COLLEGE LONDON

**2002** APPOINTED AS THE UK’S FIRST UK SECURITY AND INTELLIGENCE CO-ORDINATOR

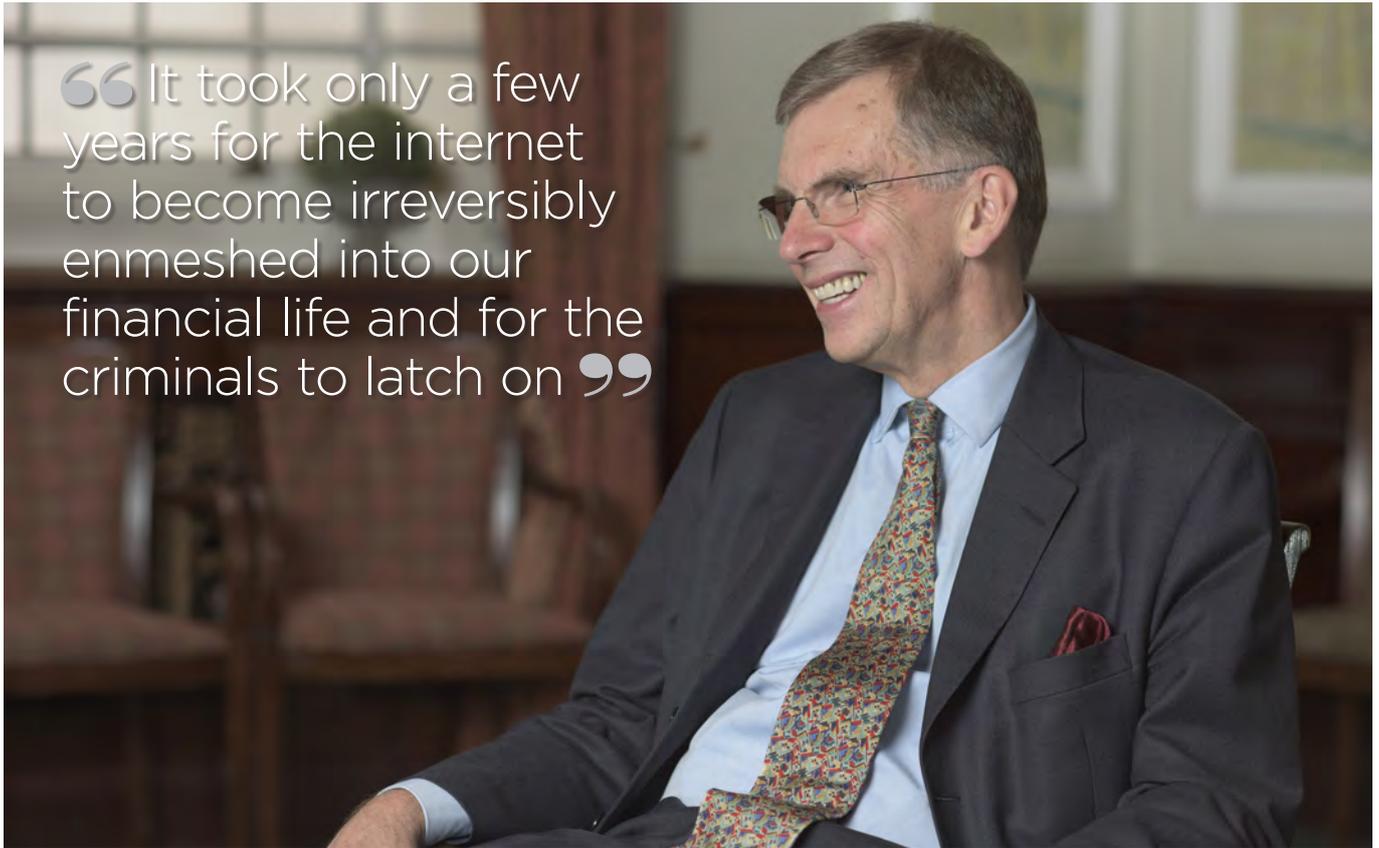
**1997-2000** PERMANENT SECRETARY, HOME OFFICE

**1996-1997** DIRECTOR, GCHQ

**1993-1996** DEPUTY UNDER SECRETARY OF STATE FOR POLICY, MINISTRY OF DEFENCE

**1969** JOINS GCHQ

“It took only a few years for the internet to become irreversibly enmeshed into our financial life and for the criminals to latch on”



points out, noting the recent campaign that took at least \$300m from banks around the world, with some sources estimating that the impact has been in excess of three times that amount.

“We must also expect further examples of attempts to spook the market with false rumours spread through social media, such as the hacked Twitter feed that reported explosions at the White House with the US President injured. Not a new thought – of shorting in anticipation of rumours you know will spread – but the internet makes it all too easy.” In that case, the Dow Jones lost more than 140 points in six minutes, with the S&P 500 alone losing market cap of \$136.5bn. Traders, meanwhile, plunged into ten-year Treasury bonds. The Syrian Electronic Army claimed responsibility in support of President Assad. “More Russian connections?” Sir David wonders.

“All these dangers will be accentuated by the advent of the Internet of Things, which will within a few years have connected the 50 billion objects and instruments of daily life – our roads and bridges, cars, water and electricity meters, our homes,

our appliances, our clothing, and much more. Gartner [an American information technology research and advisory firm] predicts a \$14tn market by 2020. Many of these machine-to-machine transactions will involve financial payments that represent new avenues of financial vulnerability, increasing the attack surface presented to the criminal or hostile group.”

*“All these dangers will be accentuated by the advent of the Internet of Things”*

#### SUCCESS STORIES ON THE RISE

“Over the last year, digital intelligence methods, of the type exposed most unhelpfully by Edward Snowden,” says Sir David, “have been used against different types of cyber crime and against the new illegal hacker sites on the Darknet. This remains a largely unpoliced space due to the use of anonymisation tools such as Tor to hide those operating illegal websites.

“The last year saw Operation Tovar mounted by the FBI, Europol and the UK

National Crime Agency to take down one of the largest-ever criminal peer-to-peer botnets run by one of the world’s most wanted criminals, Evgeniy Bogachev, who wrote the GameOver Zeus attack. That netted more than \$100m from financial fraud alone, quite apart from the proceeds from the Cryptolocker ransomware that the botnet also planted on innocent victims.

“Bogachev is indicted in the US, and the FBI is offering a \$3m reward, but he continues to live in security in Russia. The Russian authorities have not arrested him. So Operation TOVAR succeeded in taking down that botnet. But it showed there is a safe haven for cyber criminals in Russia. The gang has now launched two much more sophisticated versions of their malware, Drydex and Dyreza, that fix the flaws that the FBI exploited.”

#### BRITAIN’S NEW INTERNET LAWS

Legal systems have struggled to keep up with the demands created by new technologies. The UK Government published a draft Investigatory Powers Bill on 5 November. It aims to overhaul the laws governing how British police and



intelligence agencies can access and study the communications and data of their suspects and other forms of digital data to fight crime, terrorism and other threats to national security, and support the UK's economic wellbeing. On both sides of the debate – heads of security agencies and privacy campaigners – there is widespread agreement that it is time for Parliament to look again at the complex law in this area and make it easier for citizens to know where they stand. As an independent Royal United Services Institute commission on which Sir David served said earlier in 2015, the authorities need a new democratic licence to operate in the digital space.

Sir David is well attuned to the issues, but blunt: “Law enforcement agencies need to be able to track the bad guys on the internet: the cyber criminals but also the dictators, terrorists, child abuse networks, people smugglers, drug traffickers and all the other enemies of an open society.

*“Security and privacy are not alternatives. We need both and we can have both”*

“Of course, mining any digital data that relates to individuals has to be conducted throughout with respect for the privacy rights of the individual, and with proper legal authority,” he adds.

“Nations need to establish new social compacts between legislators, government agencies, industry and the public to ensure that fundamental rights to respect for privacy and freedom of expression are not compromised by a search for security regardless. They also need to ensure that the duty of government to provide security for its citizens is not compromised by society insisting upon unworkable restrictions on the ability of the authorities to gather data on their suspects.

“Security and privacy are not alternatives. We need both and we can have both if we stick to the three Rs: Rule of law; Regulation and oversight; and Restraint in their use, so that these powerful digital tools – and the use of more traditional human agents and informers – are at all times governed by the principles of legality, necessity and proportionality.”



Ikony/Emma Griffin

# Where angels like to tread

ANGEL INVESTMENT IS GROWING IN POPULARITY IN THE UK AS A FUNDING MODEL FOR BUSINESS START-UPS. WHAT SORT OF RETURNS CAN INVESTORS EXPECT AND HOW CAN THEY MINIMISE THE RISKS OF THIS TYPE OF INVESTMENT VEHICLE?

◆ EDWARD RUSSELL-WALLING

Well-heeled investors should devote 10% to 12% of their spare wealth to angel investments. That is the view of Jenny Tooth, Chief Executive of the UK Business Angels Association (UKBAA). Her opinion is not unbiased, given her role. But in explaining what angels are, and how they differ from other less traditional types of investor, Tooth makes a compelling case for angel investment.

“It’s an evolving market, but essentially an angel is an individual investing their own money directly in a business and retaining a level of personal involvement,” she explains.

“The most important thing about real angels is that they bring added value alongside their money in the form of their skills and knowledge.”

*“It could be eight years before you see any return, and 50% of your investments could die”*

That knowledge could be professional or it could relate to a particular industry. In the past, angels have been retired people looking to use their experience, but they

have now been joined by a wave of full-time younger people from business and financial services backgrounds, as well as by successful entrepreneurs.

Whoever they are, these angels have plenty of opportunity. Although banks are less willing to lend to new businesses, entrepreneurs are still looking for money, and funding models are changing as a result. We have seen the rise of crowdfunding and peer-to-peer lending, for example, though neither is as hands-on as angel investment (see box on p25), which is becoming increasingly popular with investors. ◆

## ANGEL DELIGHT



MORE THAN  
HALF OF ANGEL  
SYNDICATES  
AND NETWORKS  
CREATED SINCE  
**2010**

ALMOST  
**60%**

OF ANGELS REPORTED THAT THEY  
HAVE EXPERIENCED A POSITIVE EXIT  
SINCE THEIR FIRST INVESTMENT



MEDIAN



INVESTMENTS PER ANGEL

HIGHEST NUMBER OF  
INVESTMENTS BY ONE ANGEL  
**50**

**58%**  
OF ANGELS INVESTING  
ALONGSIDE CO-INVESTMENT  
FUNDS HAVE LESS THAN  
**5 YEARS' EXPERIENCE**

## UK BUSINESS ANGELS BY GENDER



Source: *A nation of angels: Assessing the impact of angel investing across the UK*

According to Tooth, there are around 18,000 angels in the UK, investing perhaps £1.25bn a year – more than three times the level of venture capital investment in the UK. This form of equity finance was a major factor behind a record number of UK business start-ups in 2014/15, with the Institute of Directors reporting a record 586,000 start-ups over that period – up 10% from the previous year and up 23% since 2011/12.

### SAFETY IN NUMBERS

To be of use to a typical business, an equity investment needs to be at least £100,000, but an individual angel doesn't need to invest that much. Angels are increasingly investing in groups or syndicates and pooling their finance and skills, typically with an experienced lead angel. They also spread their risk across a number of different investments, knowing that some

of these investments – quite possibly the majority – will fail.

The UKBAA advises would-be angels not to invest only in one business and not to do it alone. It also recommends that angel investment should be part of a diversified portfolio, adding that angel investment is smart capital but also patient capital.

“It could be eight years before you see any return,” Tooth cautions. “And 50% of your investments could die. But one or two of them could be snapped up by venture capital or private equity.”

Entrepreneur Peter Cowley was the UKBAA 2014 Angel Investor of the Year. He agrees, warning that those considering becoming angel investors should not get into it if they are simply looking for a quick profit. “What attracts me to angel investing is not necessarily the return; it's the fun of

the process, meeting the people, seeing the technology, the markets and learning from the whole process.”

The angel principle is that one or two winners will more than make up for all those losers – but the odds appear to be improving. According to the UKBAA's 2015 study *A nation of angels: Assessing the impact of angel investing across the UK*, angels reported a lower rate of low returns and a higher rate of expected higher returns than in previous research, which indicates considerable confidence in the market. The study also found that more than four out of ten investments were expected to generate a return in the range of one to five times the initial investment.

Because it is keen to encourage start-ups, the UK Government has removed much of the risk associated with angel investment. Its Enterprise Investment Scheme (EIS) and, more specifically, the Seed EIS (SEIS) protect the downside, while leaving the upside unlimited.

“Tax is not a reason to do it,” Tooth cautions, “but it does provide a safety net.”

With SEIS, investors get 50% tax relief up front, with no tax on profits and tax relief on any losses. This means that even if the business fails completely, SEIS investors cannot lose much more than 20% of their money.

### KNOWING THE MARKET

Such safeguards are encouraging angel investment. Few investors have been as successful as Michael Blakey, the UKBAA's Angel Investor of the Year for 2015. He points out that not every angel has to have knowledge that is directly useful to the company. “There are two ways of angel investing,” he says. “One is to be actively supportive and the other is to be a silent investor. But if you want to be a silent investor, make sure you are teaming up with someone who has a lot of experience.”

*“People prepared to do a number of rounds generally get better returns”*

Blakey's original experience came from working in a technology start-up business. He invests with his brother, who brings finance and strategy skills. They have

invested in around 40 companies, participating in more than 70 rounds of investment in those companies. “People prepared to do a number of rounds generally get better returns,” he emphasises. Blakey and his brother have funded companies from a wide range of industries, including drinks, logistics and cosmetics, the latter providing them with one of their best investments. They put money into Pout, a cosmetics business founded by three women. “It was a sector I knew little about, but I was impressed by the team,” he recalls. “And I was impressed by some of their investors, who included Tom Singh, the founder of New Look.” The brothers participated in a number of rounds of investment and enjoyed a successful exit that gave them a healthy return.

*“I fell in love with the opportunity and ignored warnings from people I trust”*

Cowley’s most successful venture so far on the other hand, has been in the world of financial technology. He has sat on the board of Arachnys, a platform used by investment banks when conducting due diligence on potential clients, for four years. “We’ve got 60-odd banks, consultancies and corporates using us on a regular basis, a sales office in Manhattan and 25 people based in the UK just behind the Gherkin.”

And while great things can come from angel investing, it’s not always plain sailing. Blakey’s worst experience was in a business he doesn’t want to identify but which typified some of the mistakes that angels can make. “I fell in love with the opportunity and ignored warnings from people I trust, as I’d become too emotionally attached to it,” he says. “I also had doubts about the management team, which turned out to be justified.”

He also admits that even after realising early on that this company was going nowhere, he spent another year hoping to get back some of the amount he had invested. “When you no longer believe in an opportunity, just walk away,” he advises, “and then focus on the companies that are doing well.”

Cowley has war stories of his own, including investing in a couple who went on to become husband and wife, with a child to follow shortly after: “The business wasn’t hugely far

along, although it was profitable, when the founder realised he needed a proper job, so he then gave up.” He adds that while there are no guarantees of success, there are ways to improve the odds. He gives several tips for increasing the chances.

First, he recommends securing a relationship with the investment director: “They’re the ones that are protecting your money. They’re the ones that are able to veto or support things. Having a relationship where you can have a chat about deals is very important.” Secondly, he endorses taking opportunities to add value when appropriate: “Even small stakeholders will have a network and experience. Don’t push yourself onto an entrepreneur, but certainly be around for them.” Finally, he says that staying in one’s comfort zone in terms of sector can soften the blow if it doesn’t work out: “If a failure occurs, one should only blame oneself for investing. You’ll feel much easier doing that if you know you understood the business, rather than blindly following somebody else.”

#### REASONS FOR FAILURE

Of course, many companies fail. And there are many reasons why. Maybe the product just didn’t work, or it took longer than expected to gain traction, and the business couldn’t sustain its funding. There might have been a competitor or two that they, and you, didn’t know about.

Cowley says that asking enough questions when investing in a later-stage business, such as one that is past its first, second or third round of funding, is vital. “Not doing enough due diligence can be pretty fatal. Three of the four failures I’ve had have been exactly that. You’re going into a business thinking it is priced correctly, which it may be, but the history isn’t easy to get at or has not been released.”

*“You meet amazingly interesting people, with the chance to get your hands dirty”*

Most common of all, according to Blakey, is that the idea is good but the management cannot execute it. He explains why this is often the case. “The founders of start-ups are incentivised, but it’s hard for them to recruit a strong team because they can’t afford good people,” he says. Blakey reckons that while it

#### PEER FACTOR

Along with angels, crowdfunding and peer-to-peer lending are very much at the forefront of alternative investment.

With crowdfunding, start-ups typically use the internet to raise many small amounts of money from a large number of people.

This can be in the form of equity, debt or even a donation, but the investors are remote from the business – they will never meet the management team, for example.

Peer-to-peer lending, on the other hand, is lending directly to businesses or individuals, for a defined period and is often secured against assets.

Again, this is a hands-off transaction with no personal involvement.

is not for those who dislike rollercoasters, angel investment can provide an opportunity to make a lot of money. “You meet amazingly interesting people, with the chance to get your hands dirty and have a great deal of fun,” he says.

It is an experience that the UKBAA is keen to promote, and encourages those interested in understanding more about angel investing to take advantage of the range of information and resources available on the UKBAA website, or to participate in the new e-learning courses coming on stream in 2016.

The association is also discussing the establishment of a continuing professional development course with the CISI to enable members to learn more about angel investing. Tooth explains: “We want to help CISI members to better understand the market opportunities, so they can raise awareness among their client base about something that could be interesting and exciting in their portfolios, as well as doing some good.”

#### ➤ Further information

To find out more about angel investment, visit the UKBAA website at [ukbusinessangelsassociation.org.uk](http://ukbusinessangelsassociation.org.uk)

# Risk and reward

THE ROLE OF CHIEF RISK OFFICER WAS IN THE PROCESS OF SLOWLY EVOLVING, BUT SINCE THE GLOBAL FINANCIAL CRISIS, IT HAS TRANSFORMED IN BOTH SCOPE AND IMPORTANCE

◆ ROB CLARK



The notion of risk has shifted over the past few years, from being an interesting but largely peripheral management concept to becoming a vitally important management practice. In part, this is a response to the 2008 financial crisis and a more rigorous regulatory environment, but that is not the whole story. It also reflects a growing appreciation that risk, and risk management, is a part of the business to which financial services companies need to pay greater attention.

This has been highlighted by the problems at The Co-operative Bank, which almost collapsed in 2013 and which now faces regulatory fines from the Financial Conduct Authority (FCA) and the Bank of England (BoE) over its capital shortfall in the period after the financial crisis.

James Lam, a specialist risk management expert who is widely credited with coining

the term ‘chief risk officer’ back in 1993 when he worked in that capacity at GE, says: “Early on I had predicted that the role of Chief Risk Officer (CRO) would become prevalent, and that has come to fruition.

“I think it was becoming more accepted globally in any case, but the financial crisis was a strong wake-up call for those on the sidelines or on the fence.”

*“For the first time, the CRO is typically regarded as one of the ‘big three’ executive positions”*

“The financial crisis has highlighted the need for this role,” agrees Victoria Stubbs, CRO at The Cambridge Building Society, where the role is a board position. “It’s an increasing trend across businesses. People can see it’s important because of my being on the board.”

Stubbs’ view of the growing importance of the CRO role is supported by a report by executive search firm Hedley May, *The post financial crisis chief risk officer: the teenage years*, which found: “For the first time, the CRO is typically regarded as one of the ‘big three’ executive positions, alongside the CEO and CFO [Chief Financial Officer].”

## WHAT IS A CRO?

A CRO is responsible for identifying, analysing and mitigating internal and external events that could threaten a company. The officer works to ensure that the company is compliant with government regulations and reviews factors that could negatively affect investments or a company’s business units.

If everyone agrees on the importance of a CRO, however, the precise function of that role can prove hard to pin down. “It does mean different things to different people,”

says Stubbs. “It’s a relatively new discipline and the job description is very broad.”

Hanna Kam, CRO at insurance group Hiscox, agrees: “Hiscox has always had someone in that role, but it has become more formalised and the role remit has changed. I’ve been in this specific role for almost a year now and much of that time has been spent in formalising its function.”

The risk function used to be largely an operational one, but these days it is likely to encompass a more strategic approach. Today’s CRO is often involved in policy making, not only in ensuring that the business complies with heightened risk management expectations (from government, regulators and shareholders), but also in evolving an overarching risk management framework.

*“Risk and compliance used to be put in a corner, but now they are central to everything”*

Kam says she challenges and tracks risk throughout the company: “That challenge isn’t always about not taking the risk. Insurance is the business of taking risk from our customers. It’s just as likely to be me saying: ‘Are we taking enough of a risk?’ People don’t realise that.”

Lam – whose seminal book *Enterprise Risk Management* was republished last year, ten years after it first came out – agrees. “Companies with strong CROs are making more informed business decisions and are better compensated for those risks through risk-based pricing,” he says.

“Individually, I have found people to have a good understanding of risk management within their areas,” says Kam, “but Hiscox is a big and diverse group of businesses, so the challenge is how to widen that knowledge beyond their own areas so it encompasses the whole of our business. Our internal audit function asks questions about risk management to gauge whether it has improved.”

Stubbs says the whole culture has improved, and not just at The Cambridge Building Society. “The risk and compliance team used to be put in a corner,” she says, “but now they are central to everything.”

#### AN ONGOING CHALLENGE

The Basel Committee on Banking Supervision highlighted the challenges facing

a CRO, and what needed to change, in its 2013 report *Principles for effective risk data aggregation and risk reporting*, which says: “Many banks lacked the ability to aggregate risk exposures and identify concentrations quickly and accurately at the group level, across business lines and between legal entities.”

Yet less than two years later, Accenture’s January 2015 report *Remaking finance and risk for the everyday bank* observed that 92% of financial services executives were considering risk when forecasting and budgeting, 87% were factoring risk into mergers and acquisitions and financing discussions, and 84% were doing so when conducting strategic planning.

So can we infer from those figures that the battle for hearts and minds is won and that a more robust risk culture is now embedded in financial services institutions? Kam points out that there is more still to be done. “It’s a tricky area to get right, because it’s all about people,” she explains. “That makes it a very dynamic and alive area to be working in, but there are some people who want to hang on to the legacy position, or who don’t want change, or who do but want different changes. But we are on the right path at Hiscox, we have a very solid building block, the board is engaged and that cascades out across the business.”

#### THE DEVELOPING ROLE

As the role of a CRO has grown in importance, so too has the need to find the right people. Rabobank announced in September this year that it would be splitting the CFO and CRO roles rather than having them performed by the same person, as previously. This follows the BoE last year blocking Santander’s plans to combine the roles of deputy chief executive and CRO after the Prudential Regulation Authority said one person could not perform both jobs.

The profile of an ideal CRO is hard to define because of the different nature of the role within different organisations, but the ability to assimilate and understand a mass of information from a variety of sources and disciplines is vital. “The key thing is a very strong analytical capability,” says Stubbs, who adds: “The volume of regulatory change is enormous.”

Kam agrees: “A consistent level of understanding is not always easy, because regulations aren’t always written in an easily accessible way to foster good understanding.

## SPOTTING THE DANGERS

**Specialist risk management expert James Lam highlights three areas that he says CROs need to address to improve their companies’ risk culture:**

- Spotting ‘black swans’ [an event that deviates beyond what is normally expected of a situation and that would be extremely difficult to predict], such as cyber threats, global warming and pandemics is one thing, but how do you spot a ‘grey swan’ [an event that can be anticipated to a certain degree, but is considered unlikely to occur and may have a sizable impact on the market if it does occur]? How does a business change its risk appetite or capacity when it becomes troublesome?
- There needs to be a good risk performance feedback loop – what are we trying to measure, and how does the board know that it is working effectively? You can say, ‘Well, nothing bad has happened’ – in other words, that there have been no negative surprises, such as at Volkswagen recently, but that’s a negative proof. The key objective of risk management is to minimise unexpected earnings volatility – I want to be a risk optimiser rather than a risk minimiser.
- Risk management monitoring and reporting needs to be continuous and distributed to the decision-makers throughout the company. These are the ways in which we will get to best practice.

We have to present them in a way that can be understood. We manage risk very well at Hiscox, but there’s always more to be done in how we make it relatable to everyone.

“The interaction between teams across different functions within the business encourages people to be ‘risk champions’ and keeps risk at the forefront of everyone’s mind, so that considering risk in the way that we have formalised it becomes second nature. That’s the holy grail.”



# Up in smoke

HOW WILL THE TOBACCO INDUSTRY COPE WITH THE GROWING THREAT OF E-CIGARETTES? AND HOW ARE DISRUPTIVE TECHNOLOGIES AFFECTING FIRMS IN FINANCIAL SERVICES AND BEYOND?

◆ CHRIS ANDERSON

Digital disruption has become an almost inevitable challenge for business in recent years. In the last two decades, traditional high-street business models have been forced to change their ways in the face of competition from the likes of Amazon and eBay. More recently, digital alternatives have rattled the cages of other unprepared industries. Uber has gone toe-to-toe with the traditional taxicab model and proved itself a genuine contender. Meanwhile, record companies have been pitted against digital music streaming services, such as Spotify and Deezer.

Even banks, which have long relied on customer interaction, have been forced to offer online services to give users greater personal access to their finances. Long-established firms in the wider financial services sector are under increasing pressure to embrace fintech in order to keep pace with new competitors. The speedy, on-demand nature of these platforms means it is easy to see why they have become so successful, but how can industries long considered safe meet these challenges?

Earlier this year, *The Telegraph* named British American Tobacco (BAT) as one of ten

shares “you should be able to hold forever”. In the article, Bruce Stout, Senior Investment Manager at Murray International Trust, explained that even though sales of tobacco products are generally in decline, BAT in particular was still “able to raise prices because of the strong names in its stable”, such as Dunhill and Lucky Strike.

Stout may have explained why tobacco shares are known for their remarkable long-term performance, but will that always be the case?

*“Their initial reaction to e-cigarettes was dismissive; they were regarded as a fad”*

The industry landscape is starting to change, with an increasing number of smokers switching from traditional products to something either smokeless or less harmful to health in the form of an e-liquid or e-cigarette.

At present, most of the companies selling e-cigarettes are relatively new entrants into the smokers’ market. Taking the attitude of ‘if you can’t beat ’em, join ’em’, a number of long-established tobacco firms are starting to expand into this area and offer similar

products. But simply joining this burgeoning market may not be enough for these firms to maintain the level of profits to which they and their shareholders have become accustomed.

“The disruptive element of e-cigarettes is that they were not developed by the tobacco companies, and they lost control of the narrative a little bit,” explains Shane MacGuill, Senior Analyst – Tobacco at Euromonitor International, a London-based market intelligence firm. “Their initial reaction to e-cigarettes was dismissive; they were regarded as something of a fad. But due to the number of smokers taking up these products in the last couple of years, I think the attitude has changed dramatically.”

## PREPARING FOR CHANGE

MacGuill says that in the past, the share performance of the tobacco industry has been strong because it has been such a stable environment, with only a handful of big international companies dominating the market. While e-cigarettes are proving popular, they are not expected to upset that any time soon, but the industry is still looking to prepare itself for change. “In terms of revenue for e-cigarettes within the tobacco industry right now, you’re talking

minimal – around 1%,” he says. “So the industry is looking into it, not because it is taking a hit, but due to the current popularity and the potential trajectory.”

The tobacco industry’s solution is to buy up the smaller e-cigarette manufacturers, says MacGuill, in an effort to gain “control of the product, the distribution channels and the ecosystems. They want consumers only buying their products, and that’s difficult with the range of new ones coming out of China”. Keeping pace with technological innovation will be a major challenge for traditional tobacco companies, but some of the biggest players could be showing the way forward. In 2013, BAT became the first international tobacco company to launch an e-cigarette, Vype, in the UK, and the company has stated its aim to be a leader in the field.

### BRAND EQUITY

Another major challenge facing the tobacco giants is how to brand these new products. MacGuill explains: “What the industry would love to do is take a name like Marlboro, which has decades of brand equity built up and is easily one of the most valuable tobacco brands in the world, and transplant that onto an e-liquid or e-cigarette, but they are not able to do so as there is legislation to prevent that.”

Another potential nail in the coffin of the tobacco industry is the relative cheapness of producing e-cigarettes. Cost-cutting at this time is clearly a favourable option, but if a company turns its attention elsewhere, how is its traditional product and supply chain affected, and who will be the new players taking advantage?

Whatever tobacco firms decide to do next, the spectre of a big name from another industry hangs over them: Kodak, the famous camera manufacturer that filed for bankruptcy in 2012. For so long it had specialised in camera film, and when a disruptive technology in the form of digital photography arrived, Kodak decided not to embrace it, in case it damaged its existing business. The irony is that Kodak had a hand in the invention of the digital camera, but delayed committed entry to this market because of the company’s dominance in film.

### DIGITAL DISRUPTION

Tobacco is an obvious example of an industry that has been disrupted by digital technology, but the finance industry faces very similar challenges. Many UK retail banks have

embraced digital, transforming their business models to integrate web, mobile apps, phone and face-to-face customer service.

But as a whole, the banking sector has achieved only patchy success in its drive to develop digital capabilities and offerings in house – as well as its ability to monetise them. However, steps are being taken to correct this. In fact, one of the aims of the current Financial Advice Market Review from HM Treasury is to consult on the opportunities and challenges presented by new and emerging technologies, in the hope they can modernise and improve advice services (for more information on this review, see page 30).

Marie-Laure Delarue, EMEA Banking & Capital Markets Leader at EY, explains some of the challenges: “Success has been hampered by an inability to create and sustain a culture of entrepreneurialism and innovation internally. This is driving banks to increasingly look at partnering with both fintech developers and each other to develop new digital products and services.”

The professional services firm’s latest *EY Eurozone forecast: Outlook for financial services* report found that the emergence of digital technologies, such as the ‘robo-advisor’, is forcing wealth managers who have traditionally targeted their resources at the back office to invest in their front office digital capabilities or risk falling behind.

The report warns that such moves are essential in a world where digital advances, from mobile computing and cloud storage to

the emergence of social media, are breaking down the traditional boundaries between financial services and other industries, and new players are moving in from adjacent and ancillary sectors. It says: “Online retail and payments services will meld into banking. Insurance and healthcare will converge around wearable sensors, and comparison sites will migrate from price comparison to automated algorithm-driven apps to guide consumers’ selection of a diverse range of financial products.”

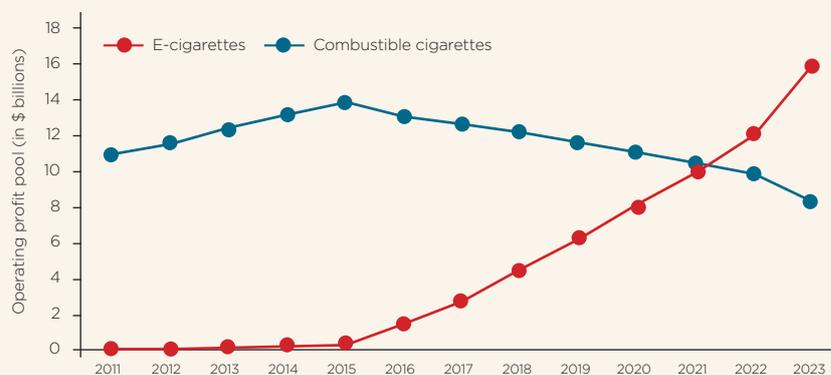
Matthew Hopgood, London-based Vice President at Sapien Global Markets, which provides services and solutions to the capital and commodity market, emphasises that a digital transformation has to go beyond technology if it is to truly succeed.

He explains: “You also have to change the attitude and the culture so that the organisation has agile thinking and adaptability at the core of what it believes.”

In an evolving world where new advancements can send shockwaves through any business, even those as organic as tobacco, things can change very quickly. Since there’s no way to halt disruptive technologies, perhaps it’s time, as Hopgood suggests, to instead inspire an acceptance of change throughout organisations.

Encouragement to consider and take new opportunities can allow staff to forge and lead new markets, rather than get left behind. In a time when new technology can go from exceptional to everyday quicker than ever, their survival could well depend on it.

### E-CIGARETTE PROFITS COULD SURPASS THOSE OF COMBUSTIBLE CIGARETTES WITHIN TEN YEARS



Sources: Company data and Wells Fargo Securities LLC estimates. Data for 2011–2013 is actual. Data for 2014–2023 is estimated

# Advice for all

THE AIM OF THE FINANCIAL ADVICE MARKET REVIEW IS TO MAKE ADVICE CHEAPER, CLEARER AND BETTER FOR INVESTORS, BUT WHAT ISSUES MUST THE UK GOVERNMENT ADDRESS IF IT IS TO ACHIEVE THESE GOALS?

◆ NICK HUBER



Getty

## BRIDGING THE GAP

One of the main questions that will confront the FAMR's expert advisory panel is: why are people not getting financial advice when they need it? The Citizens Advice Bureau says that there are four main gaps in financial advice, including "affordable advice". It estimates that an extra 5.4 million people would consider paying for advice if it cost less, while there is a 'free advice' gap of 14.5 million people who think they would benefit from free advice but have not sought any in the past two years.

"To be a success, the FAMR must establish the full extent and cause of the advice gaps," says Gillian Guy, CEO of independent charity Citizens Advice and a member of the review's expert advisory panel. "Affordability is the gap that is commonly debated, and the price of financial products and services does have a part to play. But it is also important that consumers know what types of support are available, can access them as and when they need them, and can move or be referred easily between different types of service."

But making financial advice cheaper may not necessarily mean that more people take it up. The number of professional financial advisers declined from about 26,000 in 2011 to 24,000 in 2014, according to the FCA, which cites a lack of trust in professional advisers as one of the possible reasons for this decline.

Of course, regaining the public's trust can prove difficult, as banks have found. But Martin Bamford, Managing Director at Informed Choice, believes that the profession needs to raise its game. He says: "We need to put an end to misselling scandals involving unregulated investments or greedy tax planning schemes, as these are hugely damaging to our profession and costly to the end consumer, who inevitably ends up paying compensation costs through the cost of advice."

In August this year, the UK Government announced a Financial Advice Market Review (FAMR) into how financial advice could work better for consumers. In October, together with the Financial Conduct Authority (FCA), the Government began a three-month public consultation, and plans to publish a final report before the Budget in 2016.

The FAMR follows the introduction in April this year of pension freedoms, which give people with defined contribution pensions the option of taking out all the money from their pension pot in one go. "A key part of that is making sure that people can access affordable, tailored advice and guidance to help them make informed financial decisions, whether that is saving for their first home, taking out a mortgage, buying a car or saving and investing for the future," said Harriett Baldwin, Economic Secretary to the Treasury.

*"Profit margins are put under ever-increasing strain by the cost of compliance"*

Tracey McDermott, acting CEO at the FCA, reinforced why such a review was needed. "The financial decisions people make can have long-reaching effects," she said. "It is important that the market provides accessible and affordable advice when people need it." The FAMR will analyse:

- The size and cause of a 'gap' in financial advice for people who do not have significant wealth or income and who want financial advice, but may not be able to afford it.
- Regulatory or other barriers that firms face in giving financial advice, and how to overcome them.
- Opportunities and challenges presented by new and emerging technologies to provide good value, efficient and user-friendly financial advice.
- How to encourage a 'healthy demand' for financial advice, including dealing with issues that deter consumers from seeking it.

It will be carried out by an expert advisory panel led by Nick Prettejohn, Chairman of Scottish Widows Group, and comprising 12 to 15 senior figures representing financial services providers, financial advisers and

consumer representatives. The Government is also reviewing how free and impartial financial guidance (including the Money Advice Service and Pension Wise) can be made more effective.

**FEE HIKE**

The UK's regulatory authorities have already shaken up the nation's financial advice market this decade.

Regulation changed at the start of 2013, when the FCA's Retail Distribution Review rules came into effect. Advisers were told to charge customers a fee rather than take a commission from the financial provider they picked for their customer. The rule change was intended to end the incentive for financial advisers to encourage customers to invest in products paying the highest commission. The result was that many banks stopped offering financial advice.

Obtaining financial advice from those firms that do still offer it does not come cheap. According to a survey by unbiased.co.uk, an online marketplace for financial advice mentioned in the FCA/Treasury consultation, consumers are paying an average hourly rate of £150 for professional, regulated advice. Some consumers, the FCA adds, may also find it hard to judge the value of advice because the benefits are usually deferred over time and more intangible than for purchases of non-financial products.

**AFFORDABLE ADVICE**

It begs the question: if millions of people cannot afford financial advice, is it possible to make it more affordable? Not unless the Government cuts the cost of regulatory compliance for financial services providers and financial advisers, warn some experts.

Richard Freeman, CEO of Intrinsic Financial Services and a member of the FAMR expert advisory panel, says: "The primary issue is the cost of advice. Financial planning is typically a business of thin profit margins, and these are put under ever-increasing strain by the cost of regulation and compliance."

Advice is a tightly controlled profession for good reasons, of course. But certain changes, such as cutting unnecessary, lengthy disclosure documents for regulators and clarifying the fees that the regulator and the Financial Services Compensation Scheme will charge back to the industry, would benefit both customers and the financial adviser profession, Freeman adds. ➔



Getty

“As with any industry, if the cost of compliance becomes a hindrance to innovation and growth, the net outcome will be decreased competition and less choice for the consumer,” says Freeman. He adds that improving the “economics of advice”, so that advisers do not have to either raise fees or reduce the level of service they provide in order to absorb compliance costs, will help ensure customers receive better service. Making tax rules on investments simpler and improving training for financial advisers would also help consumers get better value.

*It is not just customers that need help – advisers need protecting too*

Martin Bamford, Chartered Financial Planner and Managing Director at Informed Choice, an independent financial adviser, agrees, adding that an increase in quantity, as well as quality, of financial advisers would also benefit customers. “The advice gap could be closed by investing more in the recruitment and training of financial advisers, especially with supporting roles such as paraplanners, for which a new apprenticeship standard was recently launched.” Paraplanners support advisers in

many ways, in particular with the production of suitability reports.

It is not just customers who need help – advisers need protecting too. The Association of Professional Financial Advisers has said that it wants the FAMR to have a “fundamental rethink” of regulation of financial advice, particularly advisers being subject to unlimited liability – compensation claims from customers for bad advice.

#### MORE CHOICE

But ultimately, will the review help investors get better advice? At the very least, it should give them more choice, says Freeman. “Advisers specialise in helping clients understand investment risk and recommending investment portfolios suited to individual personal circumstances. This can’t be provided through investment plans that don’t provide advice, and the review could give more investors access to an investment plan built specifically for them.”

So there is much for the Government, the FCA and the external advisory panel to ponder as they undertake the FAMR. They know that getting financial advice right is particularly important in light of the new pension freedoms. In the meantime, the financial services industry should hope that

## LEAVING IT LATE

When it comes to planning for retirement, a joint survey conducted by unbiased.co.uk and MetLife has highlighted some significant differences between those who take financial advice and those who do not. The 2015 Value of Advice report found:

- The average age for seeking advice on retirement is **35**.
- Advisers recommend seeking financial advice **40** years before retirement.
- **38%** of UK adults are currently not saving anything for retirement.
- People are seeking advice on retirement **ten** years too late on average.
- The average amount that adults are saving towards their retirement each month is **£97**, but those who have taken professional financial advice are saving an additional **£71 per month**.
- People who have taken advice expect to have to fund a retirement lasting **37 years** on average, whereas those who have not taken advice think they will be retired for just **22 years** on average – a belief that may leave them dangerously underfunded.

consumers only speak to regulated financial advisers that can be verified through a check of the FCA’s Financial Services Register (see page 16) – and that they contact the regulator’s consumer helpline if unsure. The last thing the industry needs is another misselling story hitting the national headlines before the review is complete.

#### ➤ Further information

If you want to find out more about free and impartial financial guidance currently offered to consumers by the UK Government, go to the Money Advice Service website at [moneyadvice.service.org.uk](http://moneyadvice.service.org.uk) or visit the Pension Wise website at [pensionwise.gov.uk](http://pensionwise.gov.uk)

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Filip Fidanoski, Researcher at Ss. Cyril and Methodius University in  
 Skopje, Republic of Macedonia

Kiril Simeonovski, Junior Associate, Macroeconomic Policy  
 Department, Ministry of Finance, Republic of Macedonia

Vladimir Filipovski, Professor, Ss. Cyril and Methodius University in  
 Skopje, Republic of Macedonia

Katerina Jovanovska, Teaching Assistant, University of Ljubljana,  
 Slovenia

Simona Blazeska, Macroeconomic Analyst and Cost Control Associate  
 Sparkasse Bank Makedonija AD Skopje, Republic of Macedonia

## EDITORIAL

I'm devoting this editorial to a subject that is taking up a lot of air time in the business media: the future of banking. It seems that intermediating between those who have cash and those who need cash will eventually be the preserve of anyone other than banks; such is the high profile of P2P, crowdfunding, fintech and the like. In *The Times* of 23 October 2015, the business editorial (written by Simon English) reduced the debate to a glorious intellectual *tour de force* with the words: "Banks suck." He goes on to say that because banks sell us products that we have to have, such as current accounts and mortgages, they have us by the neck (his words, not mine) and so do not need to bother about delivering any acceptable level of customer service.

Leaving out whether one *has* to have a mortgage (one can always rent), these gross generalisations do Mr English's readers, not to mention the UK taxpayer and also the profession of journalism, a grave disservice. Banks, like people, are not all alike. Some of them are poor and some of them are less poor. Some of them offer lax customer service and some of them a reasonably acceptable customer service. If this is how Mr English writes in the editorial pages of *The Times* newspaper, I'd hate to see the quality of discourse offered up by him in an internet blog post.

Perhaps he should step into a branch of Virgin Money? The customer service there seems, from what I observed at its Haymarket branch recently, really rather good. If he is after a current account, what about the no-nonsense high quality product offered by TSB, which does pretty much everything required from a current account and also pays a very competitive rate of interest? Or if he is willing to give old-fashioned banks a chance and really does need a mortgage, perhaps try the recent fixed-rate offers from NatWest? The entire application and renewal process for this product can be done over the internet with only a few clicks of a mouse button and a minimum of fuss and paperwork (I must declare an interest here, of the three named institutions on this page, I am a customer of NatWest only).

My point is that there is some not too bad service undertaken, for millions of customers every day, by some banks. This does not mean the work of banks is done, far from it. There is much that needs improving by banks to restore their image and reputation, and to win back the trust of customers. And this is where I'd like to return to my opening theme of the future of banks.

Currently, banks are the only institutions that even purport to offer that essential ingredient of commerce: the universally available current

account with on-demand overdraft. The oldest bank still in existence, Monte dei Paschi di Siena, dates from 1472. To secure the next 500 years, banks will have to combine the best of the traditional with the best of the current. The current is the easy part – it concerns technology and digital banking. Contrary to media belief, not all customers want to carry out their banking on their smartphone. The need is for banks to offer an 'omnichannel' customer interface that embraces branch, phone, laptop, pad, mobile and video. This is not an intellectual challenge, it requires investment in time and technology know-how.

The other essential is an ability to understand customers with the same level of sophistication that is exhibited by the likes of Amazon, Google and Facebook. But banks need to achieve this level of understanding using human beings. This is because, despite what everyone says about banking being as commoditised as a tin of beans, there is a fundamental fallacy at work in that belief: a customer's requirement for a can of beans does not change over his or her lifetime. One either wants to eat beans or not. The minute beans go off the menu, the product is dropped.

However, the relationship between a customer and his or her financial needs changes over time. At age 18 the need is simple – perhaps a current account and in due course a credit card. But later in life there may be a need for a business start-up loan, a mortgage, a standby line of liquidity, foreign exchange remittances overseas ... the list is long. And at some point the customer may wish to actually talk to a banker about his or her requirements.

That's why I find it hard to accept that just because millennials like all their banking over the mobile *today*, they will always want to do it this way once they hit ages 40, 50 and 60. And to understand customers over time as their lives change requires more than just an algorithm. I hear a lot about the great customer service from Amazon and Facebook, but have you ever had any contact, by email or phone (forget face-to-face) with anyone at those companies? They understand us as computer code. Banks must learn to deliver exceptional customer service, but using that essential human element. This requires decentralisation so that local managers are empowered to authorise services to local customers, as demonstrated in recent years so successfully in the UK by Handelsbanken.

And that brings me to my last point. A quote on LinkedIn attributed to Richard Branson suggests: "Clients do not come first. Employees come first. If you take care of your employees, they will take care of the clients." I wholeheartedly agree. Too many banks, irrespective of their size, have allowed themselves to turn into bureaucratic process-driven beasts where corporate automatons engage in oblique consultant-speak every day. Platitudes abound. Senior management meetings are characterised by a turgid atmosphere where trust is minimal and no one offers comment, let alone challenge. This corporate culture must share some of the blame for the worst excesses of the crash, and must be tackled.

Transforming the working environment at banks into an open, free speaking one will go a long way to restoring the culture of exceptional customer service that, along with an omnichannel interface and a savvy executive, will ensure the future still has a place for traditional banks.

And with that, I'll take my leave of *RoFM* and bid you farewell. I hope you have all enjoyed the journal, or at least some of it! It's been a pleasure working with the CISI and I'd like to take this opportunity to thank again Simon Culhane and the recently departed Richard Mitchell; without whom this journal wouldn't have seen the light of day, and for that I think everyone at CISI should be grateful.

All the best.

**Professor Moorad Choudhry FCSI, Editor,  
 Chief Executive, Habib Bank AG Zurich, UK**

**OPTIMAL FUNDING TERM OF POSTED COLLATERAL**

Bert-Jan Nauta, Head of Economic Capital Modelling, RBS, Amsterdam  
 bertjan.nauta@gmail.com

**ABSTRACT**

This paper investigates what factors determine the optimal funding term of posted collateral. We show that it is different for the initial margin and variation margin. The funding term for the initial margin is determined by the liquidity and maturity of the derivative. For the variation margin, the funding term should be determined by the liquidity of the other assets on the balance sheet and the existing funding for these assets.

**INTRODUCTION**

Posting collateral is an excellent way to reduce credit risk in a derivatives transaction. However, it exposes the parties in a transaction to liquidity risk. Large movements in the mark-to-market (MtM) of transactions can lead to large liquidity outflows. Since MtM movements of derivatives are unpredictable and can be erratic, this poses a significant challenge to liquidity risk management.

In this paper, we consider over-the-counter (OTC) derivatives transactions that are out-of-the-money for which the bank has posted cash collateral. The collateral covers the variation margin and initial margin as prescribed by the Basel Committee on Banking Supervision (BIS) paper on margin requirements for non-centrally cleared derivatives [1]. The question we address is: what is the proper funding term for this collateral?

Since cash collateral earns the overnight (ON) rate, one might argue that it should be funded on an ON basis. However, for a 30-year swap that is far out-of-the-money, the collateral will very likely be needed to be posted for years. Therefore, even though the rate earned is ON, this is not the correct funding term.

Should the collateral then be term-funded, so that the bank is ensured to have funding for the posted collateral? This seems quite conservative for a 30-year swap. Indeed, we will show in this paper that this is not necessarily correct either.

However, here the truth does not lie somewhere in the middle, but rather somewhere else. We argue that the optimal funding term for collateral posted for variation margin is not determined by the term of the transaction, but rather by the liquidity of the other assets on the balance sheet. Only the optimal funding term for the initial margin is determined by the derivatives term and liquidity.

**FUNDING TERM FOR POSTED COLLATERAL REQUIRED BY THE VARIATION MARGIN**

Variation margin (VM) can have various features, such as minimal transfer amounts, thresholds, and collateral choice options. Here we assume the simplest case of cash collateral and daily margining without any complicating features. In particular, we assume that the variation margin equals the MtM of the derivative transaction at any time. Furthermore, this section considers only variation margin and assumes the absence of initial margin. We postpone the discussion of initial margin to a later section.

Consider the following stylised balance sheet:

A=100	L=80
	E=20

At this point, the bank enters into a swap with a counterparty. The swap turns out to be a bad investment, and the MtM of the swap decreases from 0 to -10. Therefore, the equity has reduced from 20 to 10. Also, the bank has posted 10 units of cash collateral and has issued extra debt to fund this collateral. The resulting balance sheet is:

A=100	L=80
	E=10
Posted collateral=10	Swap=10
	Debt=10

The question is: what is the right funding term for this extra debt issued to fund the collateral? Well, as may be seen from the balance sheet, an alternative (and better) interpretation is that the debt does not fund the collateral, but replaces the funding previously provided by equity.

The swap, which has turned into a liability, funds the collateral. The term of the swap and the posted collateral match exactly (under the assumptions mentioned above). In particular, when the swap matures, the posted collateral also disappears from the balance sheet. Although the issued debt provided the cash that was needed for the collateral, it replaces the funding provided by equity to the other assets. Therefore, its optimal term is determined by the other assets on the balance sheet. For example, if all the assets are ON deposits, then the issued debt should be ON as well; if these are long-dated illiquid loans, the issued debt should optimally fund these.

It may be useful to consider what happens with the above balance sheet if subsequently the MtM of the swap rises from -10 back to 0. Compared to the initial balance sheet, there is an additional 10 cash on the asset side, and on the liability side, an additional 10 debt.

A=100	L=80
	E=20
Posted collateral=0	Swap=0
Cash=10	Debt=10

The term of the debt is determined by the assets and will, therefore, be longer than the term of cash (ON). The cash can be returned to the equity holder (if capital requirements permit this), reinvested, or held as a liquid asset buffer. The debt funds 10 units of the assets and replaces the funding provided by equity before.

In general, the debt issued to post VM collateral should have a term that optimally funds the assets, given existing funding (liabilities+equity).

This conclusion is not changed if we consider a netting set with many derivatives instead of a single swap. It does somewhat change if threshold amounts and minimal transfer amounts are introduced, but it still provides a useful limiting case.

To determine the optimal funding term of other assets and initial margin, we use the framework developed in [3], which we briefly recap in the next section.

**LIQUIDITY RISK AND FUNDING**

To find the optimal funding term of an asset, we need to consider funding costs and liquidity risk.

The main idea is that liquidity risk and funding costs are, so-to-say, two opposing forces: liquidity risk pushes to longer funding terms, funding cost pushes to shorter funding terms.

Liquidity risk generates an expected loss due to events that force the bank to sell assets at a discount<sup>1</sup>. This expected loss not only depends

on the liquidity of the asset, but also on the funding term. If the asset is term-funded, the expected loss is zero. If the asset is short-term funded, the probability that it needs to be liquidated in a liquidity stress event (LSE) is larger. In that case, the resulting loss depends on the liquidity of the asset, in particular the liquidation value in an LSE.

In [3], calculations are performed by assuming a lognormal distribution of the duration of LSEs. Also, a simple, piecewise linear dependence of the liquidation value of the asset on the duration of the LSE and funding term is assumed. Using these assumptions, the expected loss due to liquidity risk can be calculated analytically.

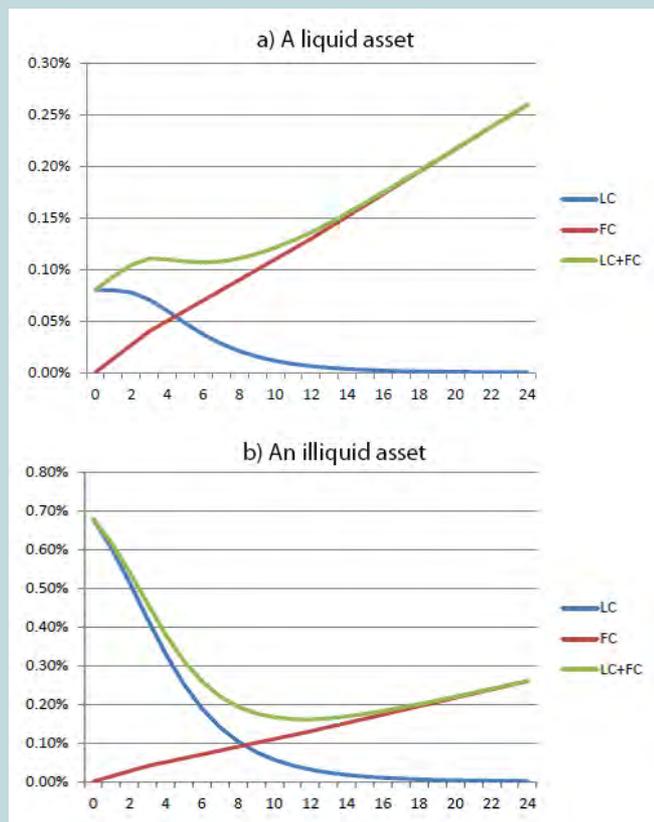


Figure 1: Funding and liquidity costs as a function of the funding term for a liquid and illiquid asset. The y-axis indicates the costs per annum. The x-axis indicates the funding term in months.

In Figure 1, examples are shown for expected loss of a liquid asset (with a minimal liquidation value of 90%) and an illiquid asset (with a minimal liquidation value of 0%). The line 'LC' denotes the expected loss (LC stands for liquidity cost). For the liquid asset, we see that the expected loss is eight basis points (8bp) for ON funding and decreases with the funding term to less than 1bp beyond one year. The expected loss for the illiquid asset is much larger at 68bp for ON funding and decreases to a few basis points at one year. In both figures a funding spread 'FC' is also included. The funding spread as a function of funding term is the same for both assets. It increases from 0bp for ON funding to 26bp at two years.

There is currently no consensus on exactly which funding curve to use. Discussion of this choice is beyond the scope of this paper. In [3], we discuss this issue in the context of valuation. The risk magazine article [2] discusses practices at different banks in the context of the funding valuation adjustment.

1. In case of securities, it may be possible to generate liquidity by repo transactions in an LSE. There could still be a loss due to an increased haircut of an off-market spread.

Furthermore, Figure 1 shows the combined costs, denoted by 'LC+FC'. The minimum of these total costs determines the optimal funding term. We see that the optimal funding term for the liquid asset is ON, and for the illiquid asset with a maturity beyond one year, the optimal funding term is 12 months in this example.

Note that the optimal funding term of 12 months depends on the assumptions made regarding the duration of the LSE. We have chosen the same parameters in this example as in [3]. The probability of an LSE is 5%, the severity of the LSE in terms of the fraction of assets that need to be liquidated is 16%, and the median of the duration of is six months. The lognormal volatility of the duration of the LSE is set at 0.5, which implies a probability of an LSE with a duration larger than 12 months of approximately 8%.

If the probability of an LSE longer than 12 months is estimated to be larger, then the optimal funding term would be larger as well. The table below shows the sensitivity of the optimal funding term with regard to the probability and the median duration of an LSE (keeping volatility and funding curve fixed).

Prob. LSE	Median duration	liquid	illiquid
5%	6m	ON	12m
5%	12m	ON	21m
5%	3m	4m	6m
10%	6m	8m	14m
10%	6m	ON	25m
10%	3m	5m	7m

Note that the optimal funding term of the illiquid asset is only mildly sensitive to the probability of an LSE, but quite sensitive to the median duration of the LSE. The liquid asset is sensitive to both parameters. The increase from ON to 8m when the probability of an LSE is increased from 5% to 10% is especially noticeable.

Because these parameters are uncertain and cannot be implied directly from market data, it may be prudent to choose a funding term that is somewhat conservative. For example, a bank's best estimate of the median LSE duration is six months. However, the bank is uncertain about this estimate, and the median LSE duration might be as large as 12 months. In that case, the bank may be prudent and chose the largest of the optimal funding term for the range of median durations, which would imply in the above example a funding term of 25 months. In the following, we will use the optimal funding term directly: 12 months for illiquid assets and ON for liquid assets.

Irrespective of specific choices, the section shows how a funding term can be estimated from choosing the optimum of the combined funding costs and expected liquidation losses.

## OPTIMAL FUNDING TERM OF COLLATERAL

We use the example of the previous section to estimate the optimal funding term for collateral posted for a five-year out-of-the-money OTC swap. We assume the swap is the only transaction in the netting set.

The swap is illiquid, and since it is a five-year swap, the volatility in the initial margin may be limited. Therefore, the funding term for the initial margin would be that of an illiquid asset, which in the previous example was 12 months.

The funding term for the collateral posted for the variation margin is determined by the liquidity of the other assets. For a typical bank, most assets are illiquid, although the bank should also hold a buffer of liquid assets. If we assume that only part of the illiquid assets are term-funded or optimally funded, then the optimal funding for the variation margin is determined by the illiquid assets and is 12 months as well.

Consider as a second example a short position in a one-month option, which we consider to be the only transaction in the netting set. In this case, the optimal funding for the variation margin is 12 months, but for the initial margin one month, clearly showing the different drivers of the funding term for initial and variation margin.

As a final example, if the optimal funding term for initial and variation margin differs, consider a liquid derivatives transaction. In that case, the optimal funding for the initial margin is ON; for the variation margin it is, as before, 12 months.

## SUMMARY

The funding term for initial margin and variation margin can differ significantly. In a netting set with a single transaction, the liquidity and term of that transaction determine the optimal funding term for the initial margin posted. The posted collateral for variation margin requirements is funded by the derivative itself. Therefore, the optimal term of the debt issued to meet collateral requirements depends on the liquidity and term of the other assets on the balance sheet. More specifically, its optimal term should optimise the value of the assets, given the term of liabilities already present.

The optimal funding term of an asset minimises the sum of funding costs and expected losses from liquidity risk. Examples for a liquid and illiquid asset illustrate the optimisation of the funding term.

Note that in case of multiple transactions in a netting set, the conclusion regarding the variation margin does not change (as long as cash collateral is posted that matches the MtM of the netting set). The initial margin funding term is more complicated to determine in that case, as it will depend on liquidity and term of all transactions in the netting set. A possible way to estimate this is to allocate the initial margin to the different transactions and optimise per transaction, but this requires further research.

## ACKNOWLEDGEMENTS

I would like to thank Camilla Erlandsdotter, Stratos Nikolakakis, and Steven van Haren for useful discussions. The paper represents the views of the author alone and not the views of RBS.

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## ASSET SWAP SPREADS AND RELATIVE VALUE

Michele Lizzio, Analyst at Mediobanca, Milan

[lizzio.michele@libero.it](mailto:lizzio.michele@libero.it)

## INTRODUCTION

Readers will be familiar with the basics of bond market instruments. An oft-used but commonly misunderstood technique in bond analysis is the asset swap spread (ASW). In this article we consider the use of asset swaps and ASW spreads to determine relative value in a credit-risky bond. Such analysis is a key part of the security selection decision. ASW spreads have been long in use in the market because the interest rate swap (IRS) is an important reference for the bond market and is used to hedge the IR risk of bonds. This type of derivative contract typically exchanges a fixed rate interest payment to the floating one, and represents a fundamental tool in terms of hedging, speculation and managing risk. The spread between swap and bonds can be used to determine the relative value of the bond, but can be measured in several ways. It is therefore important to know which method is being used and quoted. Once known, the spread is taken to indicate the richness or cheapness of bonds with different features.

## ASSET SWAP SPREAD

The asset swap is an agreement that allows investors to exchange or swap future cash flows generated by an asset, usually fixed rates to floating rates. It is essentially a combination of a fixed coupon bond and an IRS. We define it thus:

An asset swap is a synthetically created structure combining a fixed coupon bond with a fixed-floating IRS, which then transforms the bond's swap fixed rate payments to floating rate. The investor retains the original credit exposure to the fixed rate bond. The pricing of asset swaps is therefore driven by the credit quality of the bond issuer and the size of any potential loss following issuer default.

A bond's swap spread is a measure of the credit risk of a bond relative to the interest rate swap market. Because the swap is traded by banks, or interbank market, the credit risk of the bond over the interest rate swap is given by its spread over the IRS. In essence then, the IRS represents the credit risk of the interbank market. If an issuer has a credit rating superior to that of the interbank market, the spread will be below the IRS level rather than above it.

The spread of the floating coupon over the bond's market price, that is, the asset swap value is the difference between the bond's market price and par. The package of the asset swap is structured in two phases:

- at issue, the investor pays the asset (cash bond) at par
- at the same time, the investor enters in the swap contract, paying fixed cash flows equal to the coupon payment and receiving a fixed spread over the interbank rate, that is, the asset swap spread. Figure 1 shows the asset swap mechanism.

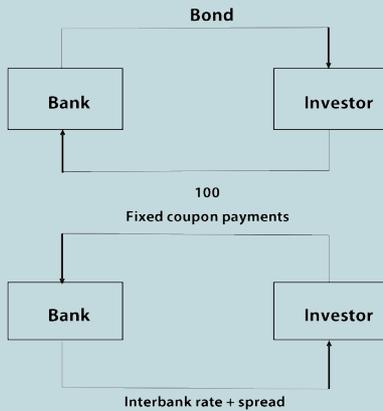


Figure 1: Asset swap mechanism.

The zero-coupon curve is used in the asset swap analysis, in which the curve is derived from the swap curve. Then, the ASW spread is the spread that allows us to receive the equivalence between the present value of cash flows and the current market price of the bond.

In an asset swap contract, the investor assumes the credit risk of the bond. In the case that the bond defaults, the investor will continue to pay the swap, without receiving the coupons and the redemption value at maturity. Therefore, the buyer of the bond takes the default exposure of the bonds. Figure 2 illustrates the bond's yield decomposition.

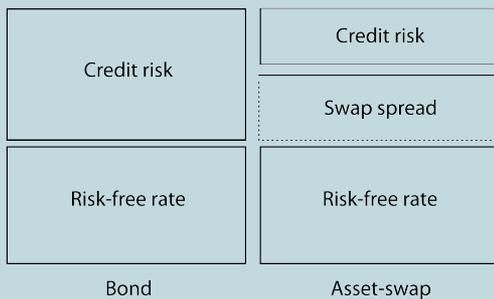


Figure 2: Bond's yield decomposition and relative ASW spread.

SWAP SPREAD FOR RICHNESS AND CHEAPNESS ANALYSIS

Making comparisons between bonds could be difficult, and several aspects must be considered. One of these is the bond's maturity. For instance, we know that yield for a bond that matures in ten years is not the same as one that matures in 30 years. Therefore, it is important to have a reference yield curve and smooth that for comparison purposes. However, there are other features that affect the bond's comparison, such as coupon size and structure, liquidity, embedded options and others. These other features increase the curve fitting and the bond's comparison analysis. In this case, the swap curve represents an objective tool to understand the richness and cheapness in the bond market. According to O'Kane (2005), the asset swap spread is calculated as the difference between the bond's value on the par swap curve and the bond's market value, divided by the sensitivity of 1bp over the par swap.

$$Parity = \frac{P^{Interbank\ rate} - P^{Full}}{PV01}$$

where:

$P^{Interbank\ rate}$ : bond's value discounted at interbank rate

$P^{Full}$ : market price of the bond

$PV01$ : sensitivity of 1bp on the coupon payment.

Let us now consider the following example of bonds issued by two companies operating in different industries. The first one is Hera SpA, an Italian company operating in the utility industry that issued the bond HERIM 3¼% 2021 (hereinafter HERIM); the second one is Telekom Finanzmanagement GmbH, a German company operating in the telecommunications industry that issued the bond TKA AV 3 1/8% 2021 (hereinafter TKA AV). Therefore, both companies issued two bonds with similar features:

- the same time to maturity (eight years)
- similar issue date (4 October 2013 for HERIM and 3 December 2013 for TKA AV)
- similar maturity date (4 October 2021 for HERIM and 3 December 2021 for TKA AV)
- the same creditworthiness with a Bloomberg composite rating of BBB
- the same currency (EUR)
- the same coupon payment (3.250% for HERIM and 3.125% for TKA AV, annual frequency payment)
- the same bond structure (bullet as maturity type, no embedded options).

Figures 4 and 5 show the Bloomberg screen for ASW analysis. To calculate the ASW spread, we use the bond's price, which is equal to 115.138 for HERIM and 114.592 for TKA AV. The swap structuring has been performed as follows:

- the same frequency payment as well as the bond's coupon structure, in this case annual
- the same day count convention, in this case actual/actual
- Euro swap curve as reference interbank curve, coherent with the bond's currency (EUR).

Depending on the reference yield curve selected and its currency denomination, the ASW spread changes. Figure 3 shows the ASW spread for different reference yield curves for TKA AV.

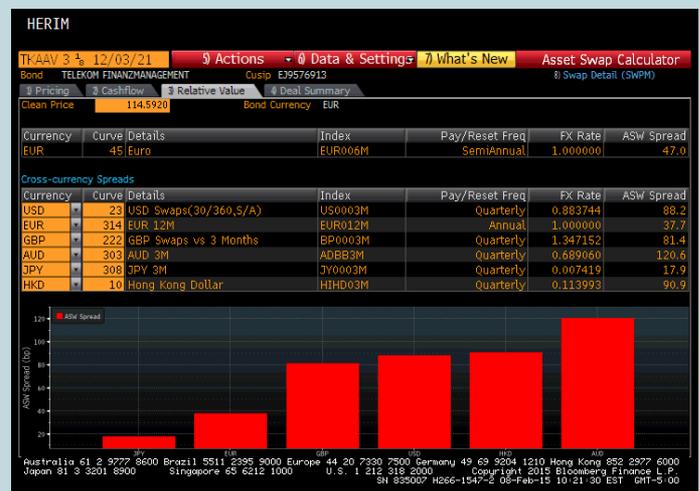


Figure 3: Relative value of TKA AV 3 1/8% 2021, on ASW screen. © Bloomberg LP 2014. Used with permission.

As shown in Figures 4 and 5, with this swap structuring, the ASW spread for HERIM is 39.5 bp and for TKA AV is 39.1 bp. These represent the spreads that will be received if each bond is purchased as an asset swap package. In other words, the ASW spread provides a measure of the difference between the market price of the bond and the value of the cash flows evaluated using zero-coupon rates.

However, a critical issue on this spread measure is how the asset swap has been structured. ASW measure works very well when bond prices trade at or near to par. Most corporate bonds trade with price away from the par (as in this case), thus making the ASW an inaccurate spread measure. If the bond trades at premium, the ASW spread will overestimate the level of credit risk; conversely, if the bond trades at discount, the ASW spread will underestimate the level of credit risk. Therefore, in the case of HERIM and TKA AV, the ASW spread overestimates the credit risk associated with the bonds, because both trade significantly at premium.

### Z-SPREAD MEASURE

Z-spread is an alternative spread measure to the ASW spread. This type of spread uses the zero-coupon yield curve to calculate the spread, which in this case is assimilated to the interest rate swap curve. Z-spread represents the spread needed in order to obtain the equivalence between the present value of the bond's cash flows and its current market price. However, conversely to the ASW spread, the Z-spread is a constant measure.

The Bloomberg ASW screen shows the Z-spread. It is 46.1 for HERIM and 45.9 for TKA AV. The Z-spread hence provides a better measure of spread, although giving a similar result in terms of an investor's decision. However, being a constant measure, it does not consider the timing of default. In fact, each cash flow has a different level of credit risk. To overcome this limitation, the Z-spread could be adjusted by introducing a probability of default for each cash flow. This other spread is referred to as adjusted Z-spread or C-spread.

### THE CREDIT DEFAULT SWAP BASIS AND TRADING ISSUES

A credit default swap (CDS) price provides fundamental credit risk information of a specific reference entity or asset. As explained before, asset swaps are used to transform the cash flows of a corporate bond for interest rate hedging purposes. Since the asset swaps are priced at a spread over the interbank rate, the ASW spread is the credit risk of the same one. However, market evidence shows that CDSs trade at a different level to asset swaps, due to technical and market factors. Although the CDSs and ASW spreads measure the credit risk of the reference name and they are driven by specific market factors, we assume that the comparison between them represents the reference credit risk. The difference between the CDS and the ASW spread is called the basis and is given by:

$$\text{Basis} = \text{CDS spread} - \text{ASW spread}$$

If this difference is positive we have a positive basis, and it happens when credit derivatives trade at higher prices than asset swaps. Otherwise, if the difference is negative we have a negative basis. Consider the following example of a positive basis trade for HERIM and TKA AV. For both bonds we calculate the CDS spread, which is equal to 86.3 for HERIM and 88.6 for TKA AV. The CDS basis over the ASW spread determined before is equal to 46.8 for HERIM and equal to 49.5 for TKA AV. However, the basis illustrated in Figure 6 is different because credit relative value (CRVD) measures it relative to the Z-spread, which is 50.7 for HERIM and 48 for TKA AV'. The basis relative to the Z-spread is equal to 35.6 for HERIM and 40.6 for TKA AV. So, we note that either the ASW spread or the Z-spread can be used as the basis performance, giving a similar result and positive basis in both cases.

An important consequence of positive basis is that the trading strategy will be by selling the underlying asset (cash bond) and selling the CDS contract on the same name, with the goal to profit by higher CDS prices and a low spread of the bond. As explained before, the CDS basis above the spread depends on technical and market factors. Among technical factors we list the following:

- **CDS premiums are above zero** – as we know, the CDS price represents a premium paid by the protection buyer to the protection seller. The protection seller, or the bank, will expect a premium, that is, a positive CDS basis over the interbank curve
- **Default protection** – the CDS size will be affected on the default event. The protection seller considers this risk on the CDS premium, increasing the basis:



Figure 4: ASW screen for HERIM 3 3/4% 2021. © Bloomberg LP 2014. Used with permission.



Figure 5: ASW screen for TKA AV 3 3/8% 2021. © Bloomberg LP 2014. Used with permission.

1. Note, these Z-spreads have been calculated with a different yield curve than the one used in Figures 4 and 5.



Figure 6: CRVD screen for TKAHV 3 1/8% 2021 and HERIM 3 1/4% 2021. © Bloomberg LP 2014. Used with permission.

- **Bonds trading above or below par** – bonds that trade away from the par will affect the basis. In our example, both bonds trade at premium, so decreasing the loss in the case of default suffered by the protection seller in respect to one of the cash bondholder. This pushes down the basis

The market factors that affect the basis are:

- **Market demand** – strong market demand from the protection buyer will increase the basis and vice versa
- **Liquidity demand** – the CDS for a cash bond may reflect a liquidity premium for that name. Therefore, for illiquidity issue, the protection requires a premium, increasing the CDS basis over the ASW spread. Note, the CDS price will be influenced also from the liquidity embedded in the synthetic instrument, which may be more or less liquid.

ANALYSIS USING MARKET OBSERVATION

We perform an analysis in which we compare bonds with similar characteristics within the same industry. This is a common analysis undertaken by bond portfolio managers looking to invest in a particular industry.

We selected five bonds rated BBB, similar maturity (around six years at maturity), trading in the European bond market. The bonds were issued by companies operating in the utility industry. The bonds are:

- SPPEUS 3 3/4% 2020, issued by SPP Infrastructure Financing BV
- RWE 1 7/8% 2020, issued by RWE Finance BV
- ENEASA 3 1/4% 2020, issued by Energa Finance AB
- IBESM 2 7/8% 2020, issued by Iberdrola International BV
- SRGIM 3 3/8% 2021, issued by Snam SpA.

Figure 7 illustrates the historical trend of the ASW spread for each bond selected. Although the bonds are issued by companies operating in the same industry and have similar ratings, they each have a different ASW spread. For instance, we can see that the ASW spread for SPPEUS 3 3/4% 2020 is around 170 basis, while the ASW spread for RWE 1 7/8% 2020 is around 20 basis.

From Figure 7 we conclude that, if we assume the credit risk is virtually identical (from a rating agency perspective and tenor perspective), the bond with the highest ASW spread will be the one we select.

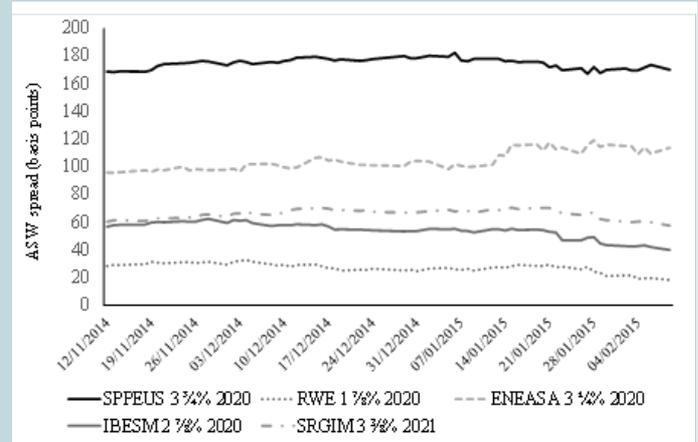


Figure 7: Historical asset swap spread for bonds traded in the utility industry. Data Source: Bloomberg.

However, it is worthwhile considering the CDS basis first, as that also gives an indication of richness or cheapness.

First we compare the basis between the CDS and ASW spread (or Z-spread). In Figure 8 we can see that higher Z-spread pushes down the basis. For instance, SPPEUS 3 3/4% 2020 is the bond with the highest Z-spread compared to other bonds, but with negative basis. The negative basis is conventionally temporary, but it represents a good opportunity for arbitrageurs who can trade across cash and synthetic markets, reverting the current trend. In this case there is a relatively lower spread in CDS market and higher spread for bond market, that is, the bond is cheap. Conversely, RWE 1 7/8% 2020 is the bond with the lowest Z-spread. Moreover, we can see from Figure 7 that the ASW spreads have low fluctuations, while the CDS spread changes over time due to the credit market sentiment. For a worsening credit environment and deteriorating economic outlook, the basis can become positive quickly. Therefore the basis will fluctuate in line with that.

However, most investors do not enter into CDS basis trades to arbitrage, they simply wish to select a cash bond. From this analysis we see that the bond we would have selected first because of its value (to us) given by high ASW also looks to be trading at the 'right' level to the CDS – that is, it is not 'expensive'. The two bonds with a positive basis would appear to be 'expensive' and so we would not, all else being equal, purchase them over the other securities.



Figure 8: CRVD screen for the industry bond's analysis. © Bloomberg LP 2014. Used with permission.

## APPENDIX 1: THE PAR ASSET SWAP SPREAD

We assume we have constructed a market curve of LIBOR discount factors where  $Df(t)$  is the price today of \$1 to be paid at time  $t$ . From the perspective of the asset swap seller, it sells the bond for par plus accrued interest. The net upfront payment has a value  $100 - P$ , where  $P$  is the market price of the bond. If we assume both parties to the swap are interbank credit quality, we can price the cash flows off the LIBOR curve.

For the calculation, we cancel out the principal payments of par at maturity. We assume that cash flows are annual and take place on the same coupon dates. The breakeven ASW spread  $A$  is calculated by setting the present value of all cash flows equal to zero. From the perspective of the asset swap seller the present value is:

$$100 - P + C \sum_{i=1} Df(t_i) - \sum_{i=1} D_i (L_i + A) Df(t_i) = 0 \quad (1.1)$$

There is a  $100 - P$  upfront payment to purchase the asset in return for par. For the interest rate swap we have:

$$C \sum_{i=1} Df(t_i) \quad (1.2)$$

for the fixed payments and

$$\sum_{i=1} D_i (L_i + A) Df(t_i) \quad (1.3)$$

for the floating payments, where  $C$  equals the bond annual coupon,  $L_i$  is the LIBOR rate set at time  $t_{i-1}$  and paid at time  $t_i$ , and  $D_i$  is the accrual factor in the corresponding basis (day-count adjustment). We then solve for the ASW spread  $A$ .

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## THE REAL EFFECTS OF BASEL III: WHERE THE DEVILS DWELL?

**The real effects of Basel III: Where the devils dwell?**

Filip Fidanoski, Researcher at Ss. Cyril and Methodius University in Skopje, Republic of Macedonia

Kiril Simeonovski, Junior Associate, Macroeconomic Policy Department, Ministry of Finance<sup>1</sup>, Republic of Macedonia

Vladimir Filipovski, Professor, Ss. Cyril and Methodius University in Skopje, Republic of Macedonia

Katerina Jovanovska, Teaching Assistant, University of Ljubljana, Slovenia

Simona Blazeska, Macroeconomic Analyst and Cost Control Associate Sparkasse Bank Makedonija AD Skopje, Republic of Macedonia

The devil finds work for idle hands

old proverb

## INTRODUCTION

A healthy and stable banking system as a key player and main engine is the *conditio sine qua non* for sustainable economic growth. Efforts to reform banking sector regulation began shortly after 2009. The global financial crisis highlighted the importance of risk and asset liability management, which is able to withstand adverse financial events. The crisis made global policymakers aware of the weaknesses of banking supervision and regulation on the one side, and the irrational behaviour and hubristic motives of bankers on the other. Scholars and practitioners around the world actively started to find a best solution which would ensure greater financial soundness. A number of initiatives were taken by the Financial Stability Board (FSB), and the Basel Committee on Banking Supervision (BCBS) focused on developing counter-cyclical policies. As a consequence, the BCBS issued the Basel III framework, and established a basis for improving and increasing liquidity. In its statement to the press, the BCBS said that it had issued "final elements of the reforms to raise the quality of regulatory capital". The reforms should strengthen bank-level, or microprudential, regulation, which will help raise the resilience of individual banking institutions to periods of stress. At the same time, the reforms also have a macroprudential dimension in addressing the system-wide risks that can build up across the banking sector, as well as the procyclical amplification of these risks over time (BCBS, 2010a).

From a practical point of view, banks created excessive leverage, primarily because of excessive and inadequate securitisation and usage of toxic derivative instruments. Also, they eroded the quality and stability of bank capital. Initially, the focus of Basel III was on increasing the capital base by introducing bank capital requirements which should accomplish different operating and strategic objectives. Basel III is changing the banking paradigm about risk and liquidity management. However, the new framework is becoming very complex, and policymakers had better cut some of the dead wood out of the earlier versions of the Basel accords for the sake of clarity. Indeed, it will not be wrong if we write that the forest of Basel III has too many trees<sup>2</sup>(Lannoo, 2011).

The foundation of Basel III was laid on top of the three pillars from Basel II (minimum capital requirements, supervisory review, and market discipline) (BCBS, 2004), which are strengthened with a new regulatory capital framework. In general, Basel III includes two quantitative metrics: Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), which will undoubtedly generate higher costs (including complaints costs). Establishing a globally harmonised framework for managing

1. This article does not represent the official views of Ministry of Finance and Sparkasse Bank Makedonija AD Skopje.

2. In his interview, Moorad Choudhry (2015), Professor at the Department of Mathematical Sciences, Brunel University, also considered Basel III as a very complex regulatory framework. He said that whether one is speaking Basel III or CRD IV the devil is now all in the detail. There are numerous technical details that remain to be ironed out. In one sentence, Basel III is too complex to be good.

of liquidity risk, especially the calibration of quantitative metrics, is challenging, given the differences in banking landscape (Gomes and Khan, 2011). The counter-arguments against Basel III emphasise that the higher capital requirements caused by raising banks' marginal cost of funding lead to higher lending rates. More specifically, large banks would, on average, need to increase their equity-to-asset ratio by 1.3 percentage points under the Basel III framework. Authors have found that **generalised method of moments** (GMM) estimations indicate that this would lead large banks to increase their lending rates by 16 basis points, causing loan growth to decline by 1.3% in the long run (Cosimano and Hakura, 2011).

To this end, the aim of this article is to discuss many academic articles about banking regulation and the results of Basel III. More precisely, our scientific efforts are concentrated on the critical observation of Basel III and the need for adopting new standards for banking. We will focus on the most important reforms that made a radical shift in global banking regulation, and at the same time we will make a critical review of Basel III in order to provide a good theoretical base for further scientific efforts.

### THE THORNY PATH FROM BASEL I TO BASEL III

Banks, as financial intermediaries, are constantly exposed to different types of risk, such as credit risk, liquidity risk, operational risk or market risk. In other words, taking risks has become the business of banking. An important question regarding the business of risk taking is the extent to which banks are willing to go in that process. (Un)fortunately, banks cannot answer this, as they do not make the ultimate decision, but the answer is short and simple: regulation. The banking industry is more regulated than any other industry in the world – even more so than nuclear power stations. If we take into consideration how harmful the effects from systemic banking crises may be, the statement mentioned above is both logical and justified. Recently, bank failures have significantly hampered economic activity and had a great impact on economic development. When people hear the words 'banks' and 'regulation' used together, they think of Basel – the rules set by the Bank for International Settlements (BIS) and its BCBS.

The new regulatory initiatives have attempted to internalise the negative externalities of liquidity risk to some extent, by shifting the costs of liquidity insurance to the private sector. This should also help to reduce the moral hazard of banks counting on the government and central bank for a bailout (too big to fail) (van den End, 2012). But, financial regulation is a complex thicket of highly technical policy challenges, with the interrelated policies often complicated further by mutually incomprehensible jargon. The devil is generally in the details, and elegant quantitative modeling of policy trade-offs is rarely available. Particularly, analytical frameworks tend to be similarly fragmented across different academic silos, including economics, financial research, accounting, political science, and sociology (Véron, 2012).

The first set of rules, Basel I, was published in 1988 with the primary focus on minimum capital requirements (BCBS, 1988). The standard defined the Tier 1 and Tier 2 capital as additive elements of the total capital. It also introduced the concept of risk-weighted assets, by classifying assets into five categories according to credit risk, that are assigned weights varying from 0% to 100%. By requesting minimum capital adequacy ratio of 8%, the aim of Basel I at first was to strengthen the soundness and stability of the international banking system. Moreover, higher transparency and comparability in international terms were also part of the goals set by the BIS. Later, having in mind the increased banks' involvement in activities

with securities and financial derivatives, their exposure to market risks combined with credit risk exposure has also become part of the capital adequacy calculation.

A significant change in the rules was made with the publishing of a new set of rules, known as Basel II, in 2004 (BCBS, 2004, 2005, 2006). In the new standard, the BCBS decided to expand its influence area by providing additional discipline on banks' risk taking behaviour. Besides the existence of a pillar on minimum capital requirements, two additional pillars were established: on supervisory review and market discipline. A novelty within the first pillar was the new method of calculating regulatory capital, covering three components of risk that banks face: credit risk, operational risk and market risk. Additionally, the framework also suggested different ways in which each of the risk components can be calculated, that is: standardised approach, foundation internal ratings-based (IRB) approach, advanced IRB and general IB2 restriction for credit risk; basic indicator approach (BIA), standardised approach (TSA) and advancement measurement approach (AMA) for operational risk; and Value-at-Risk (VaR) for market risk. The second pillar, representing supervision, was introduced with the aim of strengthening co-operation between banks and supervisory agents, such as central banks. Finally, the goal of introducing market discipline as a third pillar was the requirement for disclosure of information regarding the calculation of bank capital positions and risk management processes.

Yet not fully completed, the implementation of Basel II was marked by the onset of the global financial crisis of the late 2000s, later turning into an economic and debt crisis in Europe. This financial crisis was a mix of unique and conventional events, with underregulation or ineffective regulation being rightly blamed for playing a central role. So, one of the key challenges from this is to set up a proper degree of regulation, but what degree is appropriate has been a controversial question for almost a century. The tragic irony is that the failure of one bank can trigger the failure of other banks through interbank exposures or bank panics<sup>3</sup>. Hence, regulators must take control of banks in bad times in order to limit the losses of depositors or of the deposit insurance fund (Dewatripont, Rochet, and Tirole, 2010).

The crisis revealed failures of bank supervision and regulation, as well as the significance of liquidity risk on bank soundness and financial stability, prompting regulatory changes that subsequently lead to the introduction of a new set of rules, known as Basel III (BCBS, 2010a, 2013a, 2013b, 2014a, 2014c). The underlying purpose of Basel III, however, is not intended to fully supersede Basel I and II, but to partially amend some rules and primarily work alongside them. In that direction, the BCBS firstly undertook measures in order to increase the quality, consistency and transparency of the capital base by raising the existing minimum capital requirements and introducing additional capital buffers. Common Equity Tier 1 (CET1) capital of risk-weighted assets (RWA) required was raised to a new minimum threshold of 4.5% from a minimum of 2.0 as in Basel II, while the minimum Tier 1 capital of risk-weighted assets required was raised to 6.0% from the previous minimum of 4.0%. In addition to the higher minimum thresholds, the rules introduced a mandatory capital conservation buffer, equivalent to 2.5% of risk-weighted assets; and a discretionary counter-cyclical buffer, allowing national regulators to impose additional holdings of capital up to 2.5% of risk-weighted assets during periods of high credit growth. Both capital buffers have to be met by the CET1 capital (BCBS, 2010a). Besides capital requirements, Basel III also introduced requirements on liquidity and leverage. These requirements include: a LCR for managing short-term liquidity, requiring banks to hold greater amount of high quality liquid assets (HQLA)

3. *It is easy to think of large banks as tall city buildings. Banks are highly leveraged intermediaries, building credit volume on an equity capital foundation. Houses, like banks, are worth more when located in dynamic cities where land costs are high. Builders naturally seek to economise on lot size, depth of stone foundations, and construction material. In a city, buildings are tall and close. This experience suggests that house density, flammable construction material and excessive interconnectedness were the key causes of fire propagation. Prevention of risk propagation should be the mission of macroprudential policy, not just ex-post resolution and crisis management (Goodhart and Perotti, 2013).*

than total net liquidity outflows over 30 days (BCBS, 2013a); a NSFR for managing long-term liquidity leverage, requiring banks to hold greater available amount of stable funding (ASF) than required amount of stable funding (RSF) (BCBS, 2014c); and a leverage ratio, requiring banks to hold Tier 1 capital of at least 3.0% relative to total exposures (BCBS, 2013b, 2014a).

To sum up, it is important to note and keep in mind what financial regulation is meant to achieve. The primary rationale for regulation is to protect small depositors, holders of insurance policies, or investors in pension funds, or the public insurer of the corresponding assets, from the default of those financial institutions. The second function of prudential regulation is to contain domino effects, that is, systemic risk. But, there are many opposite views about banking regulation. Dewatripont, Rochet, and Tirole (2010) figured out and noted that regulation is too often designed to *fight the previous crisis* rather than the next one, and is typically one step behind market developments. In addition, central banks could support the regulatory efforts to reduce reliance of banks on the central banks.

### A CRITICAL REVIEW OF BASEL III

Economists, policymakers and regulators generally see Basel III as a better regulatory framework than Basel II. However, the changes made in developing the new framework are not a perfect remedy with one-sided positive effects. In fact, they can lead to adverse effects that can make it difficult for banks to meet the new requirements, and may adversely reflect on the macroeconomic environment. In other words, there are still open 'devil's holes' on the way to adjusting to the new rules imposed that have the potential to spread as contagion and grow over time. For a proper identification of these, we are going to found our review on the elementary banking concepts of capital, liquidity and leverage.

The regulatory changes regarding capital requirements can be summarised into the following two conclusions: i) increased Tier 1 capital ratio and ii) increased CET1 ratio. Since the CET1 capital makes up the core of Tier 1 capital, the second conclusion can be conveniently said to supplement the first one. In addition, the holdings of CET1 capital are also required to meet the newly introduced capital conservation and discretionary counter-cyclical buffers. The conclusions combined indicate that banks have to increase the high quality equity attributed to their risk-weighted assets, which can be done either by raising new equity or by decreasing the amount of risk-weighted assets held. If banks are willing to engage in the issuance of new equity, the higher equity will most likely lead to higher weighted average cost of capital (Kashyap, Stein, and Hanson, 2010; Miles, Yang, and Marcheggiano, 2011). This relationship can be properly explained through the dividend signaling theory (see in Modigliani and Miller, 1958, 1963) which states that a bank paying dividends at a stable rate shows credible signs of solvency and profitability, thus reducing the probability of panic among depositors and bank run during bad times (see more in Bhattacharya, 1979; John and Williams, 1985; Miller and Rock, 1985). So, the increase of the amount of equity will have to be followed by an increase of the amount of dividends paid in order to keep the rate of dividends stable. To meet the capital requirements, banks may also increase the capital ratio by decreasing the amount of risk-weighted assets. One possible way to do it is by reducing the amount of total assets while maintaining the same asset structure. Another way is to restructure by acquiring more of the safer assets and disposing of the riskier assets while maintaining the same amount of assets overall. In both cases, banks will face lower interest revenues as a result of asset restructuring, which, combined with the higher holdings of equity, have a negative impact on bank profitability. Asset restructuring and lower interest revenues also result in credit tightening, leading to higher lending rates at equilibrium and slowing down future credit growth. Furthermore, the decline in interest revenues lowers productivity of employees, and the unfavourable prospects for future credit growth resulting from the higher lending rates may cause contraction in the

amount of trade operations. Consequently, banks will need fewer employees to accomplish the reduced amount of work.

The introduction of the LCR and the NSFR as part of the requirements to deal with short-term and long-term liquidity impose the following restrictions on banks' asset-liability management: i) increasing holdings of HQLA to meet the short-term net cash outflows (up to 30 days); and ii) maintaining capital structure to meet long-term liquidity needs. As HQLA includes Level 1 assets at their market value, as well as Level 2A and Level 2B assets at their market value, reduced by applied haircuts, banks are required to hold assets that exhibit low risk, low volatility, no or very weak correlation to the risky assets and earn low interest. The amount of HQLA to obey the LCR requirement is also dependent on the amount of short-term net cash outflows or the difference between the expected short-term outflows and the expected short-term inflows. Keeping in mind that the increase of expected short-term inflows is limited by an aggregate cap of 75% of expected short-term outflows, banks will virtually have to possess at least 25% of HQLA. As for meeting the long-term liquidity requirements, banks will have to maintain a capital structure that keeps the ASF greater than the RSF. Since equity is assigned a higher ASF factor and liquid assets are assigned a lower RSF factor, the regulation is inherently pushing banks towards equity-based funding and investments to more liquid assets. These changes in the capital and asset structure will cause a decline in interest revenues, and possibly a credit tightening, with the resulting effects being the same as already mentioned. In fact, the effects are very close to those necessary to meet the capital requirements, where the only difference is that they may result from restructuring of both the short-term and long-term assets and liabilities.

Significantly, as a general conclusion, the analysis of the three banking concepts shows that new rules framed within Basel III reveal multiple sources of adverse effects – devil's holes – which will likely reflect in the banking industry as well as in the real economy. These effects tend to result in: i) lower profitability (Härle et al., 2010); ii) higher lending rates and lending spreads (Elliott, 2009; BCBS, 2010b; MAG, 2010a, 2010b; Kashyap, Stein, and Hanson, 2010; Cosimano and Hakura, 2011; Roger and Viček, 2011; Slovák and Cournède, 2011; Šútorová and Teplý, 2013); and slower economic growth (BCBS, 2010b; MAG, 2010a, 2010b; IIF, 2011; Slovák and Cournède, 2011).

### BASEL IV ANTE PORTAS

Basel III is an evolution rather than a revolution. Its ongoing implementation represents a step-by-step process, in which lower requirements are introduced in the first year, then gradually increased year by year, to be fully in place by 2019. But even in this case, it is debatable whether banks have enough time to react, and it seems that the adverse effects from these rules are unavoidable. Considering the set of rules and its implementation as they are, the main challenge for banks is surely their commitment to the rules on the one hand, and the shareholders' requests and expectations on the other, while for regulators it is, of course, the success of the framework in achieving its primary goals. Nevertheless, the implementation of the Basel Accords is a dynamic process, leading to continuous revisions and suggestions. That said, the BCBS has already published consultative documents with revision of the approaches for calculating the market risk (BCBS, 2013c), the operational risk (BCBS, 2014d) and the credit risk (BCBS, 2014b, 2015), which were deemed as an early sign for the creation of a new set of rules known as Basel IV (KPMG, 2013). Efforts were even made in defining the scope of the possible Basel IV, which will likely include (KPMG, 2013): i) requirements for banks to meet higher minimum leverage ratios, ii) simpler or standardised models rather than banks' internal models for calculation of capital requirements and iii) more detailed disclosure of reserves and other financial statistics. The healthier capital management is a central point in Basel III, and could improve the financial health of a whole market. Good and appropriate capital requirements play an important role in preventing bank runs.

Conversely, there are many bankers who will not agree with the importance of capital management in modern banking. Frankly, a large part of the banking community is not satisfied with current capital requirements, as they are proponents of a different set of measures. Furthermore, they dislike the regulation. For example, Evgueni Ivantsov of Lloyds Banking Group argues that the BCBS missed the point by focusing on capital. "Normally, financial institutions fail not because they have insufficient capital, but because they suffer unbearable losses," writes Ivantsov. "I do not dispute the idea of sufficiency of capital, but loss absorbency is no more than an 'airbag' and 'seat belt' for the banking industry's passengers. Yet regulators keep on referring to the same mantra: more capital, more capital, more capital." Some people believe that insisting only on capital targets, together with crash protection, comes at a huge cost. Consequently, recent estimates suggest US and European banks will need about €1,700bn of additional Tier 1 capital, €1,900bn of short-term liquidity and about €4,500bn of long-term funding to meet Basel III rules. Otherwise, meeting the capital requirements is only half the story. The other half is trying to run a profitable business, and to redesign the business model when so much capital is tied up. From these, we can conclude that Basel III will not realise its objectives. Therefore, many people believe that Basel IV is a strong likelihood. In other words, Basel IV looms on the horizon (Imeson, 2014).

Finally, the package of proposals about Basel III is problematic – it does not address and confront the fundamental shortcomings of Basel II. As long as the BCBS deny responsibility for the role played by its comprehensive set of accords in the global financial crash, banks and regulators will keep on receiving new provisions for Basel IV, Basel V and so on. They are in for enormous regulatory fatigue and regulatory capture, respectively. The biggest losers will be bank customers who will foot the bill for the implementation of the Basel III provisions (Moosa and Burns, 2012). One of the provisions is that after the Basel III system for bank regulation, a Basel IV system is needed in which the risk weights for sovereign debt are to be raised from zero to the level for mid-sized companies (Sinn, 2011). Basel IV should be taking into account and incorporating shadow banking into the regulatory framework (Blundell-Wignall and Atkinson, 2010) and the new and accelerating financial innovations as a cornerstone of the financial landscape (Dewatripont, Rochet, and Tirole, 2010).

## CONCLUDING REMARKS

The major economic recession and financial crisis of 2008 and the frequency of the banking crises pushed the global policymakers to make an effort to reform banking sector regulation. The BCBS, together with the FSB, introduced new counter-cyclical policies. In particular, the reforms were introduced at both microprudential and macroprudential level to reduce the procyclicality and systemic risk across the financial system. Basel II evolved into a new regulatory capital framework known as Basel III, which strengthened the previous policy. To raise the resilience of the banking sector and improve overall stability, the BCBS set higher capital and liquidity requirements in terms of quality and quantity, and better risk management requirements from the banks.

Furthermore, a set of new regulatory initiatives was applied to different monetary regimes as a global rule; however, as *one model does not fit all*, there is a need for adaptive regulation to fit different central banks' frameworks and policies. The introduced changes can lead to adverse effects, creating difficulties for banks to meet the new requirements and leading to lower profitability (because of simple market logic!). As a result of asset restructuring and credit tightening, banks will face decline in their interest revenues, further leading to credit tightening. This will consequently contract the amount of trade operations, increasing the likelihood of a reduction in bank industry employees and the negative effect on economic growth.

In sum, prudential regulation is often designed to correct some of the mistakes made in the previous crisis, rather than concentrating on

future potential crises. The regulatory focus must expand to cover the shadow banking system institutions, as they can influence financial fragility. Therefore, Basel IV is very likely to be introduced to correct some of the negative effects of Basel III. With this article, we present a critical observation of Basel III regulation to emphasise the need for an adaptation of new banking standards, and provide a theoretical base and open an avenue for further scientific research.

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**ABOUT THE EDITOR**

Moorad Choudhry FCSI FIFS is Chief Executive of Habib Bank AG Zurich, UK. His previous title was Professor at the Department of Mathematical Sciences, Brunel University and prior to that, Treasurer, Williams & Glyn at the Royal Bank of Scotland. He is also Honorary Professor, Kent University Business School and Visiting Teaching Fellow, Department of Management, Birkbeck, University of London.



Professor Choudhry is Managing Editor of the *International Journal of Monetary Economics and Finance* and on the Editorial Boards of *Qualitative Research in Financial Markets* and *American Securitization*.

He is also a member of the CISI Editorial Panel, which chooses key content for the *Securities & Investment Review*. He is author of *The Principles of Banking* (John Wiley & Sons 2012). [mooradchoudhry@gmail.com](mailto:mooradchoudhry@gmail.com)

**HAVE YOUR SAY**

If you would you like to comment on any of the articles in this issue, contact Jane Playdon: email [jane.playdon@cisi.org](mailto:jane.playdon@cisi.org) or call +44 20 7645 0648

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TOM LOW, CHARTERED MCSI, IS AT HOME WHETHER SAILING IN THE SOLENT OR THROUGH THE CHOPPY WATERS OF FINANCE

◆ LORA BENSON

# Sailing into finance

While many of us may have opted for relaxation in the sun, sea and sand for our summer holidays, Tom Low, Chartered MCSI, entered one of the toughest yacht races in the world: the biennial 608 nautical mile Fastnet race from Cowes on the Isle of Wight to the south-west coast of Ireland and back.

This year was Tom's first Fastnet race. "You race round Land's End, keeping the Fastnet Rock to port [six miles off the southernmost tip of Ireland] and back to Plymouth. It took us four days and nine hours."

Tom began working at Quilter Cheviot as an Investment Manager in October after two years at Thesis Asset Management in Lymington. He lives in Bournemouth, which, given his passion for sailing, makes perfect sense: "Living by the coast was always part of the plan, as having the sea nearby is great for indulging my hobby."

While most of his sailing has been in the UK, the Solent and the east and west coasts of Scotland, he has also sailed around New Zealand, through western Greece (as a flotilla skipper for a season) and several areas in France. "Greece is great for cruising, but nothing beats the Solent for 'round-the-can' racing," he says.

London-born Tom's route into financial services has been as diverse as his many sailing expeditions. He spent a gap year in New Zealand as a teacher's assistant and studied a BSc (Hons) Physiology at Edinburgh, then an MSc Neuroendocrinology at Oxford. Following this, he entered the financial services industry, where he worked in customer services and then as a tied adviser for Lloyds: "I was really interested in how money works," he says. "I became an international Independent Financial Adviser [IFA] based in Luxembourg, and then I came back to the UK, where I worked with Barclays as an IFA. I then began working in private banking with both Barclays Wealth and Barnett Waddingham Investments."

*"It is fantastic for building confidence. Leaders tend to flourish on yachts"*

When sailing, Tom's role is as a helm and skipper of racing yachts: "This requires organising everything for the weekend's racing, which will include knowing where the race area is and keeping an eye on weather forecasts and the tide. On the first

morning we do a safety brief and formulate a plan for the day, including which route we'll take, accounting for weather conditions and tide."

Tom caught the sailing bug at the age of 15 when his brother was sailing for the British Sailing Team in a youth dinghy class called the Cadets. He was attracted to yacht helming and skippering because he enjoys teaching and working with others in a tight and efficient team. He usually sails over the weekend, in the Sunsail fleet of F40s based out of Port Solent, but he sometimes does longer passages, such as cross-channel and the Fastnet.

He has won a total of nine Scottish university national championships, represented British university teams and taken part in the Student World Championships four times. He regularly wins the Sunsail weekends too, having come third in the finals in 2014. Tom's most memorable sailing trip was a qualifier for Fastnet: "I was up on deck at 4am, so I saw a wonderful sunrise. Then a pod of 20 dolphins joined the boat for about half an hour, and it was magical watching them play by the boat when we were 20 or so miles offshore."

Out of all sports, Tom feels that sailing epitomises that important team spirit: "I cannot think of another sport that requires so many people doing their particular skilled action at precisely the right time in collaboration with others," he says.

"It is fantastic for building confidence, getting to know your own strengths and weaknesses and gaining respect for the weather and seas. Leaders tend to flourish on yachts. All these skills are transferable to the business world. You get to learn a fantastically enjoyable new sport and have great fun meeting people and socialising. There's no downside."

➤ Contact [lora.benson@cisi.org](mailto:lora.benson@cisi.org) if you have a hobby you think will interest other CISI members. You will receive a £25 shopping voucher as a 'thank you' if we publish your story.



TOM BELIEVES SAILING EPITOMISES TEAM SPIRIT



# In a jam

JAVID NEEDS TO PROCESS A TRANSACTION THAT IS ABOVE THE AMOUNT HE IS ALLOWED TO APPROVE. HIS SUPERVISOR IS NOT AROUND BUT PROVIDES HER LOGIN DETAILS SO JAVID CAN COMPLETE THE TRANSACTION HIMSELF. FOLLOWING THIS, WHAT MIGHT HE DO?

Javid works at FAIRLY, in a busy operations department handling foreign exchange settlement transactions. The department is under pressure because of the volume of work, which has also resulted in some technical system issues. This has, in turn, increased the number of ‘exceptions’ that require manual processing, putting further pressure on the team.

Javid is one of five junior staff members in a team that is supervised by Claire, who reports to a ‘middle manager’, Colin. Fed up with the increased workload, Colin has given notice to leave FAIRLY, and there is no obvious replacement from within the existing team, which already needs more staff in order to maintain the level of service required and avoid expensive mistakes occurring. The team, including Colin and his replacement, when appointed, is managed by Delores – an experienced manager.

Each of the junior staff members can approve transactions up to £500,000 without sign off by a more senior manager, but all transactions larger than this must have four eyes sign off, which must include approval by Claire, Colin or Delores. Since Colin handed in his notice, although effectively he still has more authority than Claire, Delores has decided that she and Claire should approve the majority of the transactions between the two of them, which has made it a challenge to achieve the deadlines for processing the day’s work.

*Javid receives a phone call from Claire, saying she will not be in the office until 10.30am*

In Colin’s final week, with his replacement not due to start until after he has left, Delores is on annual leave, enjoying a

long-planned overseas trip to visit her family. Although a new junior team member has been brought in to help with the processing, they are not able to act as a second signatory, and so that responsibility rests with Claire and Colin, who increasingly seems reluctant to put himself out for FAIRLY and his colleagues. On Thursday morning, the day’s work contains a payment exception requiring manual processing of a payment for €100m on behalf of a major client to pay its associated company in Italy. For it to receive the required same-day settlement, it must be authorised by 11am.

Shortly after 9am, Javid receives an anxious phone call from Claire, saying that her son has been ill during the night, and so she cannot send him to school. She has arranged a babysitter, but unfortunately the babysitter cannot reach her until 9.15am, which means

that Claire cannot reach the office until 10.30am.

She checks with Javid regarding any urgent items that might be outstanding, expressing particular concern about the €100m payment. She suggests to Javid that he should get Colin to authorise the payment if she does not reach the office in time. Colin, having been in the office earlier on, is now nowhere to be seen.

Time passes and Javid waits anxiously for Claire to appear. In the meantime, Colin shows up and Javid approaches him regarding authorisation, but Colin tells Javid that he should get Claire to authorise the large payment and then disappears again. At 10.45am, Claire phones Javid again, saying that she is stuck in traffic that has not moved for 20 minutes, and she asks him whether the payment has gone through. He explains that he cannot get Colin to authorise it, and with Delores being away, there is no obvious person available whom he can approach.

Claire is very concerned about this and tells Javid that she will give him her login details which will enable him to add her 'authorisation' to the payment, since failure to make the payment will have serious repercussions for the firm and for both herself and Javid. Colin clearly does not care and Delores, being on holiday, can hardly be blamed.

*Failure to make the payment will have serious repercussions for the firm and for both Claire and Javid*

Javid is uncertain about the propriety of what Claire has told him to do, but goes ahead anyway and the payment is made. Shortly after midday, Claire arrives at the office and expresses relief that the payment has been made. However, she also suggests that she and Javid must now consider what

further action, if any, they should take. Javid, relieved that what could have been a major problem has been averted, is taken aback by this and suggests they might:

- report the matter to Delores when she returns to the office on Monday
- do nothing. The payment has been made with the necessary authorisations, albeit one of them was obtained in an irregular manner
- escalate the matter to the business head, although conscious that it might result in action being taken against them
- let Claire handle it; it is her problem, as he was only doing what he was told.

#### WHAT WOULD YOU ADVISE?

Visit [cisi.org/inajam](http://cisi.org/inajam) and let us know your favoured opinion. The results of the survey and the opinion of the CISI will be published in the March 2016 print edition of the *S&IR*.

## CONFLICT OF INTEREST: THE VERDICT

**The dilemma in the September edition of the *S&IR* concerns a company, JBC, that its shareholder, Bravura, wishes to sell. The Bravura shareholders require the existing management team to market the business to obtain the best possible price. Members of the management team wish to undertake a management buyout (MBO), but the shareholders are disinclined to pursue that exit route. What is the proper response from management?**

The options were:

- A** The owners of the business should hire an independent third party to conduct the sales negotiations. The existing management can then decide whether and to what extent they are prepared to be involved in the sales process.
- B** The directors have a legal responsibility to the shareholders and a fiduciary responsibility to the firm's clients. They cannot pick and choose the extent to which they will be involved in the sales

process. Accordingly, they must support Bravura.

- C** The directors should seek to persuade Bravura that they will be constructive and fair in marketing JBC, and will be happy for any final sale decision to be made, following a recommendation to Bravura by an independent third party.
- D** The behaviour of Bravura is unreasonable in expecting current management to conduct a sale of JBC while refusing to listen to an offer from the current management. Accordingly, they must be prepared for the management to be less than helpful, unless they offer them a significant financial incentive.

Of the 62 readers who responded, there was little to choose between their views of three of the four options, which saw percentage choices of 37%, 34% and 29% for A, B and C respectively, with no votes for option D.

In essence, there is no entirely right or wrong answer, and although no reader voted for option D, it is an entirely

plausible scenario that recognises the realities of the situation. In option A, the attraction of hiring a third party to market the business is that it would remove any management bias. However, the management cannot then decide the extent to which it will be involved in the process. Either they support the shareholders or resign. From the shareholders' perspective, though, that may seriously damage the sale prospects, and thus there must be a commonality of interest, which really is the response to all three courses of action.

The owners and managers should have similar interests. Option B also may be said to recognise reality, but again, the extent to which they may be 'supporting' Bravura is difficult to measure, unless they are actively acting against them.

In our view, Option C would seem to offer a compromise that should satisfy both 'sides', since the sales process is being overseen by a third party and the management are allowed to bid, without being the 'preferred bidder' from the outset.

# Soundbites and small print

THE IMPORTANCE OF LOOKING PAST TAX HEADLINES IN  
ORDER TO OFFER CLARITY TO CLIENTS

◆ TONY WICKENDEN, Jt MD, TECHNICAL CONNECTION



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As finance professionals, we all know better than to take a government (or opposition) soundbite at face value. And we've had quite a few tax-based soundbites to consider over the past year or so.

Three recent examples spring to mind: no tax on pension death benefits; £1m passing inheritance tax (IHT) free; and less pensions tax relief for high earners.

Each headline on its own looks eminently sensible – appealing even. So what's to question? Well, quite a lot of detail actually. And clients who could be affected by these changes need informed advice. It's absolutely essential that they understand what those

headlines actually mean. And to do that, they will need a clear explanation delivered in an understandable way, so that they can decide what, if any, action to take.

The 'no tax on death benefits' headline came from the Chancellor at the Conservative party conference in 2014, about the time of (and arguably to deflect attention from) the defection of the aptly named Mr Reckless to UKIP.

What Mr Osborne said was: "There are still rules that say you can't pass on to the next generation any of your pension pot when you die without paying a punitive 55% of it in tax. I could choose

to cut this tax rate. Instead, I choose to abolish it altogether."

That may have been his intention, but in fact, like the other two quite concise and superficially easy to understand soundbites:

- it's not strictly true; and
- it requires a mass of enabling legislation and guidance to make it work.

And the problem is that the very process of producing it gives rule writers the opportunity to introduce small print and conditions. These will (obviously) not have been referenced in the soundbite, but they will limit the number of people who can

benefit from the process and thus limit its tax cost to the Treasury.

And that's what your clients will need to know. Basically, "How does the change affect me?" And, "What, if anything, do I need to do about it?" The neat thing about conditions introduced at the legislative stage is that people have the headlines, but not the detail. They will very rarely pore over the legislation. Why would they? This is a variation on the stealth tax theme if ever there was one.

In relation to the promise "to abolish it [tax on pension death benefits] altogether", the magnitude of the difference between this statement and reality is quite spectacular. Most obvious is that the payment of death benefits is tax free (however it's received, as a lump sum or income drawdown) only if you die under the age of 75. Die at age 75 or over and it's all taxable. The tax rate on a lump sum is 45% if paid in this tax year and at the recipient beneficiary's rate if paid from the next tax year.

### *Clients with meaningful levels of pension funds need clarity on the tax position*

If the lump sum is paid following death at age 75 or over to a 'non-qualifying person' from 6 April next year, for example to a bypass trust, the rate will remain at 45%, but there will be a tax credit available to any beneficiary who (eventually) receives a payment from the trust taxable as pension income. Drawdown payments made following the death of a member aged 75 or over will be taxed as pension income at the receiving beneficiary's income tax rate.

Clients with meaningful levels of pension funds are likely to need clarity on the tax position, plus an understanding of the (unjustifiably complex) rules relating to who can receive death benefits and in what form. Keeping death benefit nominations and expressions of wishes under regular review is, as a result, essential. Who better than their financial adviser to do this and to make them aware of the potential pitfalls and opportunities?

Number two soundbite: "A couple can leave £1m free of IHT." That may well be what is understood by your clients, leading them to think there's no need for them to worry too much about it. It's up to you to ensure they

are informed about this. The legislation supporting this change to IHT in the shape of a new residence nil rate band is positively labyrinthine. It runs to ten pages of the Summer Finance Bill 2015.

The key messages to impart to your clients in relation to this new IHT relief are as follows:

- It doesn't start until 6 April 2017
- It's not an increase in the nil rate band to £1m, or even £500,000. Instead it's the introduction of a new residence nil rate band (RNRB)
- This new RNRB will end up at £175,000 (in addition to the ordinary £325,000 all asset nil rate band), but starts at £100,000 and gradually (over four years) moves up to £175,000
- You can have only one qualifying interest in one property
- The property has to have actually been used as your residence at some point
- You have to leave your interest to a qualifying individual, broadly a direct lineal descendant
- You can't leave your interest subject to a trust, other than a bare trust
- The relief gets cut back by £1 for every £2 that your estate exceeds £2m
- For the purpose of this relief, and specifically its cutting back, no account is taken of any reliefs, such as business property relief and agricultural property relief, in determining the value of your estate.

So that's not quite what your clients might have had in mind when they thought about this new IHT relief. It's your responsibility to explain how, and to what extent, they will benefit, if at all, and then to factor it into their estate planning strategy.

On to the soundbite of cutting back pensions tax relief for high earners. What this really means is a gradual reduction of the annual allowance for those caught. It's often stated that only those 'earning' more than £150,000 are caught, but it's not that simple.

It's actually those with 'adjusted income' of more than £150,000 that could be caught. Broadly speaking, in determining adjusted income, you have to take account of all income (including all investment income, for example, interest, dividends, rents) and add back all employer pension contributions and

all contributions made by the member under the net pay system.

The guidance notes to the Finance Bill on adjusted income make it clear that annual allowance tapering is likely to affect many more individuals than one might think.

But that's not the end of it. There's another test that might exclude some, who would otherwise be caught, from suffering the annual allowance reduction. Broadly speaking, even if you are caught under the £150,000 'adjusted income' test, you will be excluded if your 'threshold income' is below £110,000. Threshold income is broadly income from all sources, but without adding back either personal pension contributions (made under the net pay system) or employer pension contributions.

Complicated enough? And keep in mind that, in practice, you will only know for sure what your income level will be after the end of a tax year. If you are caught, then your annual allowance will be reduced by £1 for every £2 that your adjusted income exceeds £150,000. This goes on until the £40,000 starting annual allowance is cut back to £10,000. This is as low as it can go, and you reach it when your adjusted income hits £210,000, assuming, of course, that your threshold income exceeds £110,000. There will be very few of your clients who will know this detail.

And a related, but important change, is the need to align pension input periods (PIPs) with the tax year leading to some transitional 'PIP alignment' changes and, probably, planning opportunities for this tax year. Many of your clients with pension arrangements will need to have these changes explained to them and a resulting action plan constructed. So, three simple statements leading to three very strong reasons for advisers to inform and plan for their clients. And while you're about it, don't forget yourselves and your professional connections.

### Further information

Tony Wickenden's firm Technical Connection provides tax, legal and financial planning support, insight and interpretation to financial advisers and planners through an online management platform, Techlink Professional, covering tax, trusts, financial and estate planning, and much else besides, all with automated CPD logging facilities. Visit [www.techlink.co.uk](http://www.techlink.co.uk) for full details and a free trial.

# A step in the right direction

THERE HAS BEEN MUCH CRITICISM OF THE NUMBERS USING THE GOVERNMENT'S PENSION WISE SERVICE, BUT IT IS STILL A HUGE STEP FORWARD FOR FINANCIAL GUIDANCE IN THE UK

◆ ANDREW DAVIS    ◆ JOHANNA WARD



**B**y now it should go without saying that pensions are one of the most highly politicised subjects you could choose. Pensioners are heavy users of public services as well as being more inclined to turn out and vote than most other groups. At the same time, Britain has a very low savings rate by international yardsticks, and so worries about the sustainability of the pension system continue to grow. Small wonder, then, that the financial affairs of older generations are the subject of such intense political interest.

Since 1997, we have seen massive political intervention in the UK. Many blame the then Chancellor Gordon Brown's controversial dividend tax change that year for hastening the demise of final salary schemes. Last year, the Office for Budget Responsibility calculated that between July 1997 and 2014, an extra £117.9bn in tax revenues flowed into the Treasury as a result of Brown's abolition of the dividend tax credit. That is a lot of pension saving that didn't happen.

## GUARANTEEING RISES

More recently, there has been the introduction of the 'triple lock', guaranteeing annual rises of 2.5% a year in the value of the state pension (far ahead of wages over the past few years and, if you listen to the gloomier forecasters, rapidly propelling the UK towards bankruptcy if it is not abolished pretty soon). Then last March, in Budget 2014, the Government unveiled the 'pension freedoms' that came

into force this April. Chancellor George Osborne sprang his surprise reform of the rules on the House of Commons with characteristic flourish: "Pensioners will have complete freedom to draw down as much or as little of their pension pot as they want, anytime they want. No caps. No drawdown limits. Let me be clear: no one will have to buy an annuity."

It's no surprise that just six months after the pension freedoms became law, the controversy they generated showed no sign of fading. The Work and Pensions Select Committee produced its *Pension freedom guidance and advice: first report of session 2015-2016* in October, warning that the reforms were "endangering savers" because too few people understood the difference

*The truth is that we have no idea what success should look like at this very early stage, so rushing to judgment is particularly pointless*

between regulated advice and unregulated 'guidance' of the sort provided by Pension Wise, the free service set up by the Government to help people work out how to exercise their newfound pension freedoms.

The committee makes a valid point. But how hard is that distinction to explain in reality? I recently heard Henry Tapper, founder of Pension PlayPen, which advises UK companies on

workplace pensions, set it out with admirable clarity: "Advice is when we tell you what to do. Guidance is when we set out your options." Put in those terms, the problem seems eminently surmountable.

## RECEIVED WISDOM

There has also been much criticism of the numbers using the Pension Wise service. During the first six months, about 220,000 people accessed some or all of their savings under pension freedoms, but just 20,000 received guidance from Pension Wise, whether face-to-face (via the Citizens Advice Bureau) or on the phone (via the Pensions Advisory Service). About 1.5 million visitors accessed the Pension Wise website over the same period. The wide discrepancy between the number of people



taking advantage of guidance sessions and those exercising their freedoms is generally taken to show that the Pension Wise service is somehow failing to fulfil its purpose. If so many people are either unaware that they can access it or feel they have no need of it, is not something very wrong?

Maybe, but not necessarily. For a start, the whole exercise in pension freedom was based

on the populist proposition that people do not need telling what to do with their own money. Rewind to March 2014, when Osborne ridiculed the "patronising view that pensioners cannot be trusted with their own pension pots", while the then Chief Secretary to the Treasury, Danny Alexander, added: "It's a matter for people to choose how they spend their money." Neither of these declarations implies that making decisions about how to manage your retirement savings is difficult and complex, and that most people need professional help to get it right. Quite the opposite, in fact.

Second, who is to say that 20,000 guidance sessions out of 220,000 represents a failure anyway? Until last April, there was effectively no market in at-retirement pension advice, because most people had no real choice about what to do with their money. The truth is that we have no idea what success should look like at this very early stage, so rushing to judgment is particularly pointless.

Instead, take two steps back and look at the situation again. Britain is on the way to having a free, face-to-face financial guidance service for everyone over 50 who is making plans for their retirement. There is much still to do, as the Financial Advice Market Review makes clear (see p30). But there is also the potential for a far better outcome than most of us would have thought possible even a year ago.



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KBW Associates Ltd  
14-16 Dowgate Hill  
London EC4R 2SU  
+44 (0) 203 051 8617  
[keith@kbwassociates.co.uk](mailto:keith@kbwassociates.co.uk)

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Links to relevant websites



Pop-up definitions

## Ebooks available now\*:

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- Derivatives (Level 3)
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- International Certificate in Wealth & Investment Management
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- Introduction to Investment (Schools)
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## Coming soon:

- Client Money and Assets
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- Corporate Finance Regulation
- Derivatives (Level 4)
- Islamic Finance Qualification
- Managing Operational Risk
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- Platforms, Wealth Management and Service Providers
- Securities (Level 3)
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- UK Financial Regulation
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The use of online videos and voice functions allowed me to study at home and on the go, which helped me make more use of my time. I would recommend this as a study aid as it accommodates a variety of learning styles.

Billy Snowdon, Team Leader, Brewin Dolphin

\* Release dates subject to change (updated 18/11/2015)