

# the review

PROVIDING INSIGHT AND ANALYSIS FOR FINANCIAL SERVICES PROFESSIONALS

CISI.ORG/REVIEW

Q4 2018

**CISI**  
CHARTERED INSTITUTE FOR  
SECURITIES & INVESTMENT

TEN YEARS ON FROM  
THE CRASH, HOW HAS  
THE SECTOR CHANGED?

IN SEARCH OF RETURNS  
ON INVESTMENT IN  
DIGITALISATION

LEARNING FROM  
THE LIBRARY  
OF MISTAKES



## The lifelong learner

WE MUST ALWAYS BE LEARNING,  
SAYS NEW CISI CHAIRMAN  
MICHAEL COLE-FONTAYN MCSI

# welcome

“Michael has had a ringside seat to many momentous changes in the financial services sector over the past four decades”



Welcome to our new chairman, Michael Cole-Fontayn MCSI. Michael has had a ringside seat for many momentous changes in the financial services sector over the past four decades, and is keen to apply that experience in support of the CISI's promotion of knowledge, skills, professionalism and integrity in financial services. Turn to page 32 for the full interview.

What have we learnt in the decade since the financial crisis? Can we prevent it from happening again? These questions and more are addressed in our special report, which includes 'Learning lessons' (pp.26-28), a guided tour around the Edinburgh-based Library of Mistakes, led by Martin Flanagan, former city editor of *The Scotsman*; and 'Where are we now?' (pp.21-25) – a look at sector action, government interventions, regulatory changes and the effect on individuals since the crash.

We also address the related question of how to measure where we are now. 'Taking the P out of GDP?' (pp.29-31) delves into the efficacy of GDP as a measure of the size and health of an economy, noting that "in today's post-industrial age, most economic activity takes place in the services sectors rather than in factories where output can easily be counted".

Other highlights include our 'Grey matters' dilemma on GDPR complications (pp.44-45); and our *Review of Financial Markets*, which "delves into some of the issues that new adults are expecting the financial world to consider" (pp.54-65).

As ever, we welcome your comments and suggestions. What do you think of *The Review* print edition? Tell us by filling in the survey on the facing page and returning it to the freepost address for your chance to win a £100 Amazon voucher.

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# CISI.ORG/REVIEW

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100110  
011001

## Watch



### Financial Planning Annual Conference 2018

A look back at some highlights from this year's conference, held at the Hilton Birmingham Metropole, 1-2 October

## MOST COMMENTED ON

**Grey matters ethical dilemma: World tour**

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

**Regulatory update September 2018**

[cisi.org/rusep18](http://cisi.org/rusep18)

**Why flexible working is good for business**

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

## Learn



**AUTUMN BUDGET PROFESSIONAL REFRESHER**  
Distinct pass numbers: 62

## Q3 MOST READ

**City view: Call for more detail in the new FCA directory**

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

**Why your job title matters**

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

**DFMs and financial planners: managing objectives**

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

## Read



**THE DOS AND DON'TS OF MENTORING**

How mentors and mentees can benefit  
[cisi.org/mentoring](http://cisi.org/mentoring)

## EVENTS

The Accredited Financial Planning Conference 2019 will be held from 5 to 6 March. Save the date!



To read more, visit [cisi.org/review](http://cisi.org/review)



VISIT [CISI.ORG](http://CISI.ORG) TO GET ACCESS TO ALL THIS GREAT CONTENT

## MEMBER BENEFITS



Save 18% on holiday insurance



20% off Dell accessories



12% discount on Eurostar



5% off IKEA voucher



# Fraud – who cares?

WHY ARE AUTHORITIES AND BANKS SO SEEMINGLY COMPLACENT ABOUT FRAUD AND SCAMS BELOW THE VALUE OF £100,000?

In the first six months of 2018, a total of £145m was lost in the UK to criminals as a result of ‘authorised push payment scams’, where a fraudster tricks a victim into sending money to an account that they control. Of this, a paltry £30.9m has been recovered.

Given the extensive work that banks must now undertake on Know Your Customer (KYC) processes, and the distinctive pattern that the payments surrounding a fraud like this tend to follow, why are so few of these cases resolved? Are they genuinely difficult to crack, or does it reflect an attitude of acceptance among those who are meant to be policing the system?

In a recent case at a charity, criminals hacked into the email systems of a supplier and created a false invoice which the charity paid, transferring a five-figure sum to an account operated by fraudsters.

None of this money has been recovered and nobody, including the receiving bank, the police and Action Fraud, has seemed the slightest bit interested in discovering anything about the fraud, whether it was avoidable, and to confirm whether any action has been taken to catch those responsible.

## Unanswered questions

There are several unanswered questions about external processes. Had the receiving bank done its KYC properly on the account? Was the account set up by fraudsters, or was an innocent account hijacked? Do banks not have computerised alerts set up to spot an unusual sequence of transactions? (A five-figure sum was transferred in and a multitude of smaller payments went out within the hour.) Where did the money go? Did the bank take any steps to chase after it?

When the charity was made aware of the fraud (the supplier had checked the remittance note against its bank statement and failed to see the money coming in), it called the receiving bank, which would not provide any information for confidentiality reasons.

The charity then rang its own bank, which instructed its fraud department to make a request for information to the receiving bank. The receiving bank was asked again – after the 20 working-day period for the response had expired – and eventually revealed that there was money in the account. Another week went by before it was confirmed that this amounted to just £10. No further information has been received to date.

## // GOVERNMENT INVESTMENT TO TACKLE ECONOMIC CRIME AND ILLICIT FINANCE IS TINY //

A representative from the fraud department at the charity’s bank spoke to the charity, ostensibly to explain how things worked, what had happened and what action had been taken. But he simply described the process of waiting 20 days and did not provide any useful information, apart from saying that he could not remember any conversations he’d had with Action Fraud concerning any amount less than £100,000.

The charity appears to have hit a brick wall in its attempts to discover what has happened to the money and to retrieve it. Why, given how difficult it is to open an account and comply with anti-money laundering processes, is the bank not able to trace where the money has gone?

While it is encouraging that the UK government has announced an investment of £48m over the next 18 months to tackle economic crime and illicit finance, this figure is tiny compared to the £190bn lost to fraud in 2017, of which £121bn was procurement fraud, such as the one suffered by the charity.

Surely these substantial losses are worthy of a greater effort? ●

# AROUND THE GLOBE

The CISI's international network of offices looks after 45,000 members worldwide

# 60,000

The number of global candidates who have completed the CISI online ethics test, IntegrityMatters

## JORDAN

**Regional director Middle East:** Matthew Cowan, Chartered MCSI



In September, we signed a memorandum of understanding (MoU) with the Jordan Securities Commission (JSC) to provide an effective framework for collaboration to enhance and promote professional standards, skills and ethics in the capital market sector of Jordan.

The JSC will mandate CISI qualifications to the financial services sector throughout Jordan, using the CISI International Introduction to Investment as the core qualification in the programme.

The CISI will provide and award international certifications, and the JSC will mandate CISI certifications linked to the provision of licensing.

H.E. Mohammad Alborani, CEO of the JSC, is pictured left with Matthew Cowan.

## UNITED KINGDOM

**Chief executive officer:** Simon Culhane, Chartered FCSI

Congratulations to our new chairman, Michael Cole-Fontayn MCSI (pictured), who was formally elected at the CISI Board meeting on 10 October. Michael brings 35 years' experience in financial services to the role.



**+** Turn to page 32 for the full interview. Scan the QR code to view Michael's welcome message.

# 89%

of member survey 2018 respondents support moving to a digital membership card from a plastic membership card

## NIGERIA

**Senior international manager:** Praneet Shivaprasad



We have partnered with the Nigerian Stock Exchange (NSE) to provide training for our qualifications in Nigeria, under the auspices of X-Academy, the knowledge platform of NSE.

X-Academy will be offering both face-to-face and online training for our International Introduction to Securities & Investment; International Certificate in Wealth & Investment Management; and Certificate in Derivatives.



Pai Gamde, chief human resource officer of NSE, said: "This partnership is testament to the years of investment we have made in pushing the boundaries of financial education and stimulating investors' participation in the Nigerian capital market. We are excited about this development and we look forward to a long-lasting relationship with the CISI."

## SPAIN

**Country head:** Rosa Mateus

The Spanish regulator, the CNMV, has added three CISI certificates to the official list of qualifications that comply with MiFID II in Spain.

They are:

- ▶ Introducción Internacional a los Valores y la Inversión
- ▶ Certificado Internacional en Gestión de Patrimonio e Inversiones
- ▶ Certificado Internacional en Gestión Avanzada del Patrimonio

## KAZAKHSTAN



Academic Council of the Astana International Financial Centre, says: “This is an important milestone in the development of our close working relationship with the CISI.”

Our CISI test centre in the offices of the Astana Financial Services regulator went live in November. This new test base saves candidates a round-trip of 2,000km to the nearest facility. Professor Alexander Van de Putte, chairman of the



## PHILIPPINES

**Country head:**

Andrella Guzman-Sandejas



St. Scholastica’s College in Manila has integrated the CISI’s Fundamentals of Financial Services into its financial management programme – the first all-women’s college in the Philippines to do so. The University of Santo Tomas has also formally agreed to include the qualification as an elective to students. The CISI has also been granted membership into the Industry Board of Adamson University, wherein the institute may contribute to the development of a more competitive curriculum.

## SRI LANKA

**Country head:** Rajiv Perera MCSI



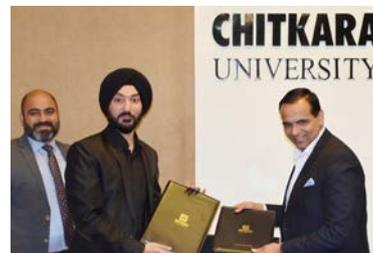
The CISI’s office in Sri Lanka has relocated to enable further expansion. The office provides support to all CISI’s international operations, and deals predominantly with operations for the APAC and Middle East, with a call centre providing support to members and students throughout the region.

Crystal Martil, operations manager and the first ever staff member in Sri Lanka, said: “When the institute began its operations here in 2011, we had only five staff members. Today, we have 39 employees and therefore outgrew our previous premises. Our increasing links and visits between offices enable us to understand cultures and people, which contributes to our continuous commitment to being a global organisation.”

## INDIA

**Country head:** Ganesh Iyer

We have announced a partnership deal with Chitkara University, Punjab, India, which aims to give students a competitive edge for a career in the global financial services sector. Jasneet Bindra, CISI India assistant vice president, is pictured second from left at the official signing.



Students will be studying for the CISI Investment Operations Certificate (IOC). Chitkara University will be sponsoring 50% of the costs of the IOC exam and training, which students will be expected to repay once they become employed.

Ganesh Iyer, country head, said: “Over the years, the CISI India office has partnered with many universities with the help of financial services sector participation, and has seen improvement in pass rates. Chitkara University is a respected institution and is our first such collaboration in the north of India. The CISI’s IOC exams meet the global standards and help to fill the talent gap in the sector.”

# INTRODUCING FINANCIAL SERVICES TO JERSEY STUDENTS



We held our second annual Insight event for school and college students in Jersey on 3 October 2018 at Intertrust’s offices in the financial district of Saint Helier.

Nearly 30 practitioners from 12 financial services firms spoke to 20 students from four secondary schools on the island about careers in financial services.

The afternoon began with a session called ‘A day in the life’, where practitioners spoke about their backgrounds, how they came

to work in the financial services sector and what their roles entail.

The second session provided students with a networking skills masterclass, where they learnt about tools to enable them to network effectively with strangers. After creating their own elevator pitches, they honed what they had learnt during a speed-networking session.

During the second half of the afternoon, students heard about the opportunities

and challenges that advances in technology will bring for the sector in the future, as well as learning more about the importance of ethics and integrity to financial services.

The event made a big impact on all who attended.

One student said: “It helped me view finance in a different light and enabled me to see the possibilities available and directions that I could go in after finishing A Levels. The insight into the different jobs and careers within finance was intriguing.”

Another said: “It was so interesting to learn all about what a day in the financial services sector is really like for professionals. I managed to refine my ideas about what career I may want to pursue when I finish school. I really liked the workshop that gave tips about how to ace an interview and make a good first impression.”

- If you or your firm can offer support to our education work in Jersey and in other regions, please contact [educationdevelopment@cisi.org](mailto:educationdevelopment@cisi.org)

## CISI Membership Survey 2018

Congratulations to Helen Howcroft, managing director at Equanimity, for winning our membership survey 2018 draw. Helen’s name was selected at random out of 2,701 respondents to win a Sonos One Voice Controlled Smart Speaker, worth £199.

Helen, pictured receiving her prize from Richard Bennett, CISI regional director, said: “I’m absolutely thrilled, as are my boys. They have already started fighting over who gets the speaker.”



## LONDON ANNUAL DINNER 2018

Mark Carney, governor of the Bank of England, was guest speaker at our London annual dinner, held on 9 October 2018 in the exquisite surroundings of the Egyptian Hall at Mansion House.



Over 240 guests contributed £4,443.30 to our nominated charity, the Lord Mayor’s Appeal, which is involved this year in supporting Place2Be, a mental health charity for children; OnSide Youth Zones, dedicated to providing leisure centres for young people; and the Samaritans, a charity that provides emotional support to those in need.

Thanks to our sponsor for the evening, First Trust, one of our financial planning corporate supporters.



## Events preview

We offer many opportunities to help you meet your requirements for professional development. Below are just some of the highlights of the institute's CPD events programme, but for comprehensive details and to book, please visit [cisi.org](http://cisi.org) and click on the 'Networking & events' section. Please note that dates listed below are subject to change.

### LONDON CPD

- 11 DEC** Five reasons not to let some thunder scare you out of equities
- 13 DEC** Young Professionals Network: Growing your personal brand
- 13 DEC** Meetings with potential clients – exploring contexts
- 9 JAN** Risk Forum: systemic risk
- 18 JAN** Diversity pays dividends
- FEB [DATE TBC]** The dawn of the age of the 'xennial': what it means for finance
- 7 FEB** Young Professionals Network: Mental health and stress in the workplace
- 7 MAR** Young Professionals Network: Become a black-belt negotiator

### REGIONAL CPD

- 11 DEC** Pensions update (Isle of Man)
- 9 JAN** Recent and impending tax wrapper changes (Henley-on-Thames)
- 15 JAN** Brexit – ten weeks to go; Pension transfers (Guildford)
- 23 JAN** Outer stress to inner peace (Birmingham)
- 24 JAN** Passive vs. active investments (Guernsey)

### SOCIAL EVENTS

- 1 FEB** Guernsey branch annual dinner 2019
- 28 FEB** Northern Ireland annual dinner 2019
- 22 MAR** Jersey branch annual dinner 2019
- 9 MAY** Liverpool, Chester & North Wales annual dinner 2019

- If you have an idea for an event or would like to contribute at one of our events, please email [cpdevents@cisi.org](mailto:cpdevents@cisi.org)
- For details of conferences and social events available to members, please visit [cisi.org/events](http://cisi.org/events)

## Disciplinary action: Charalampos (Harry) Bertsouklis ACSI

Following a notification that Mr Bertsouklis had been subject to disciplinary action by his employer, he was invited to appear before a disciplinary panel. The panel, having considered the matter and the member's submissions, determined

that Mr Bertsouklis was in breach of the CISI Membership Regulations and Code of Conduct, and that he should receive a reprimand and be required to complete the CISI IntegrityMatters test within a three-month period.

CISI members agree to abide by the Membership Regulations. An important aspect of this is the obligation to promptly inform the institute of any matter which may impact your suitability to remain a member. Failing to do so may be considered as an aggravating factor in a disciplinary case.

We are currently recruiting for members to join the Disciplinary Panel and Appeals Panel. Should you wish to register your interest please send a CV and covering letter to [standards@cisi.org](mailto:standards@cisi.org)

## QUICK QUIZ

The Review's quick quiz features questions from CISI Professional Refresher, an online learning tool. This popular product consists of more than 100 modules covering topics including anti-money laundering, the UK Bribery Act, information security and data protection. The answers are on page 47.

**1. In terms of cryptocurrencies, 'Crypto Valley' is located in which country?**

- A** The US
- B** Switzerland
- C** Japan
- D** South Korea

**2. Which of these is generally considered to have been a root cause of the 2008 financial crisis?**

- A** Some US banks had lent aggressively to 'sub-prime' borrowers who could not afford to repay their home loans
- B** Overly conservative lending policies by US banks
- C** High-frequency programme trading, leading to equity market volatility
- D** Failure of leading hedge funds, requiring an emergency Federal Reserve bailout

**3. Which of these is not a function of the Federal Reserve?**

- A** To determine US corporate tax rates
- B** To conduct US monetary policy
- C** To promote the stability of the financial system
- D** To promote the safety and soundness of individual financial institutions

**4. When are retail foreign exchange traders able to trade?**

- A** 12 hours a day, 5 days a week
- B** 24 hours a day, 5 days a week
- C** 12 hours a day, 7 days a week
- D** 24 hours a day, 7 days a week

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, visit [cisi.org/refresher](http://cisi.org/refresher) or contact the CISI on +44 20 7645 0777.



# Financial planning news

*A message from Jacqueline Lockie CFP™ Chartered FCSI, CISI head of financial planning*

## A SUCCESSFUL YEAR AND PLENTY TO LOOK FORWARD TO

As we come to the end of 2018, we reflect on a successful year for financial planning at the CISI. With the number of people now in the Financial Planning Professional Forum standing at over 3,500, those interested in financial planning now comprise 15% of the non-student membership, and this figure is growing all the time. We've seen a big step forward in engagement of the financial planning community and I'd like to thank all those who have helped run events, speak at branch meetings and conferences, and particularly those of you who have taken time out to contact us with ideas and feedback. Your help is very much appreciated. It takes every one of us to push the profession of financial planning forward and grow it to be the profession of choice in the financial services world; one that really makes a difference to people's lives.

'Changing Lives' was the theme of this year's financial planning conference. That's exactly what financial planners do on a daily basis, and we are determined to do the same for the profession.

### Looking forward to 2019

In January, we will launch an 'Ambassador Scheme', which will incorporate coordination of press comment, branch meeting support/speakers and a Financial Planning Mentoring Scheme to help support anyone interested in knowing more about financial planning; be that as a new profession or existing wealth management and financial advice

professionals looking to understand how they can offer a financial planning service to their existing clients. Financial planning means 'sticky money' from a business perspective. We know that. Offering a lifetime planning service to clients means that they stay with you, they know you and you know them. It's a win-win! It would be fantastic to see everyone helping to raise awareness of financial planning and the value of the CFP certification. Do you know anyone who might benefit from the mentoring scheme? Are you interested in being a mentee yourself or perhaps a mentor if you are a CFP professional? Visit [cisi.org/ifpforum](http://cisi.org/ifpforum) or contact us at [financial.planning@cisi.org](mailto:financial.planning@cisi.org). If you are a CFP professional and are interested in offering your expertise for press comment, then look out for an email asking for your details, or contact us at the address given above. Together, we can continue to raise the profile of financial planning in the public psyche. Financial Planning Week in the UK and IOSCO's World Financial Planning Day, held as part of World Investor Week, were both a great success in helping the public understand how beneficial financial planning can be. Help us build on that for 2019.

We can also look forward to the new CFP examination pathway next year. One with clearer assessment criteria and training support – the building blocks for others to become financial planners. It will be significantly enhanced. Many of you have said

how beneficial the CFP certification process has been to your business and its long-term strategy and profitability. Let's all work together to support others to achieve the same.

We'd love to see more of you attend local branch meetings. Collectively, we can spread the word about financial planning and help anyone new to the profession understand what it is all about. Look on the website for CPD events around the UK and on the Financial Planning Professional Forum page for meetings in London. If you are interested in joining a local branch committee, talk to the person hosting the meeting or contact me at [jacqueline.lockie@cisi.org](mailto:jacqueline.lockie@cisi.org) and I'll put you in touch with the relevant person. The more financial planning input we receive, the better.

### Save the dates

By now you should have received 'Save the date' emails for the Accredited Financial Planning Firms™, Paraplanner and Financial Planning Conferences for 2019. Remember to put them all in your diary.

Want to share your views on branch meetings, conference content or anything else? Please contact me, or if you'd like to talk to one of the members of the Financial Planning Professional Forum Committee, please see the website for their details and contact details.

I look forward to seeing you all at various events and conferences in 2019.

A happy and prosperous New Year to you all.

# 'WHAT ABOUT ZERO?' ASKS DR QUINTIN RAYER, HEAD OF ETHICAL INVESTING AT P1



P1 Investment Management has a strong commitment to ethical and sustainable investing and provides a managed portfolio service. One area of concern is investor response to climate change – better described as global warming, which over 97% of peer-reviewed scientific papers agree is primarily caused by human activities generating greenhouse gas emissions, mainly carbon dioxide.

The 'zero' above refers to net zero carbon emissions or carbon-neutrality. Companies need to start developing strategies to work towards net zero carbon emissions. Currently, many firms are looking at emissions reductions but with no real strategic ambition for carbon-neutrality. There is a danger of falling into a Malthusian trap; for example, if emissions are reduced by 10%, but the population (or the carbon-based economy)

grows by 10%, we are back where we started. This problem is only avoided when emissions reach zero, or carbon-neutrality is attained. However, few companies appear to have business plans to achieve net zero emissions.

When P1 asks ethical and sustainable fund managers about the carbon dioxide emissions of their holdings, many are exploring reductions, and some are divested so that their portfolios are fossil free. However, almost no fund managers challenge company managers on how they are going to develop a strategy to get to zero net carbon emissions. Yet this will be essential if global warming is to be contained. It will also need to be addressed urgently to meet Paris agreement targets and scientists' strongest recommendations yet to keep global warming to no more than 1.5°C above pre-industrial levels (which already accepts some impacts from global warming). So here is a challenge from P1 to ethical and sustainable fund managers – for all your holdings – encourage company management to develop strategies to achieve carbon-neutrality.

[www.p1-im.co.uk](http://www.p1-im.co.uk)  
0333 241 4129

## CISI FINANCIAL PLANNING CORPORATE SUPPORTERS Q4 2018

Gold

**Aegon**

[www.aegon.co.uk](http://www.aegon.co.uk)

**Standard Life**

[www.standardlife.co.uk](http://www.standardlife.co.uk)

**Corporate**

**AIC**

[www.theaic.co.uk](http://www.theaic.co.uk)

**Dimensional Fund Advisors**

[www.dfauk.com](http://www.dfauk.com)

**Financial Express**

[www.financialexpress.net](http://www.financialexpress.net)

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[www.ftglobalportfolios.com](http://www.ftglobalportfolios.com)

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[www.ihcs.co.uk](http://www.ihcs.co.uk)

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[www.jameshay.co.uk](http://www.jameshay.co.uk)

**Jupiter Asset Management**

[www.jupiteram.com](http://www.jupiteram.com)

**Just**

[www.justadviser.com](http://www.justadviser.com)

**NS&I**

[www.nsandi.com](http://www.nsandi.com)

**P1 Investment Management**

[www.p1-im.co.uk](http://www.p1-im.co.uk)

**Puma Investments**

[www.pumainvestments.co.uk](http://www.pumainvestments.co.uk)

**Royal London**

[www.adviser.royallondon.com](http://www.adviser.royallondon.com)

**Schroders Investment Management**

[www.schroders.co.uk/adviser](http://www.schroders.co.uk/adviser)

**Transact**

[www.transact-online.co.uk](http://www.transact-online.co.uk)

**Vanguard**

[www.vanguard.co.uk](http://www.vanguard.co.uk)

## Schroders GLOBAL INVESTOR STUDY 2018: FOCUS ON RETIREMENT AND SUSTAINABILITY

### Read our 2018 report for insights into global retirement expectations and breaking down the barriers to sustainable investment

As a global asset and wealth manager, Schroders delivers a broad range of investments designed to meet the diverse needs of financial planners and advisers.

Our *Global Investor Study 2018* focuses on retirement and sustainability. It goes without saying that people would like to retire in comfort, and many strive to save and invest effectively during their working life to ensure a certain lifestyle for their golden years. How successful are people globally at achieving this? We spoke to over 22,000 people from

30 countries to explore financial expectations for retirement and how these compare to the experiences of people who have already retired.

With a view to sustainable investing, we asked the question: Would you be investing more in sustainable funds if you knew more about them? Climate change, shifting demographics and the technology revolution are reshaping our planet, our values and how we invest. Against this backdrop, sustainability has been rising on the agenda of investors.

This is reflected in the growing importance of sustainable investment funds, which invest in businesses showing strong environmental or social performances and who proactively prepare for the changes ahead.

But barriers remain for sustainable investment to reach its full potential. Performance is not a major concern, but a lack of information is currently limiting people's allocation to this asset class. Investors are keen to understand the full impact of sustainable investment, in particular how companies are held to account on issues like bribery, corruption and pollution. As sustainable investments become more widely identifiable and understood, so too will their appeal to people looking to combine profit with positive impact.

To see the results of our *Global Investor Study*, visit [www.schroders.com/en/uk/adviser](http://www.schroders.com/en/uk/adviser)



The view from Navigator Financial Planning's main office in Newry, Northern Ireland

# Rebuilding lives with cashflow modelling

**DAVID CROZIER** CFP™ CHARTERED MCSI, MANAGING DIRECTOR AT NAVIGATOR FINANCIAL PLANNING, EXPLAINS THE VALUE OF HOLISTIC FINANCIAL PLANNING

**WHEN DID YOU BECOME AN ACCREDITED FINANCIAL PLANNING FIRM™? WHAT HAS HAPPENED SINCE?**

Navigator was one of the inaugural accredited firms, and we have maintained that status every year since. We are planning to renew again this year.

**WHAT HAS ACCREDITED FIRM STATUS BROUGHT TO YOUR FIRM AND WHY SHOULD OTHERS SEEK TO BECOME ACCREDITED?**

It allows us to demonstrate that a financial planning culture pervades our whole business at Navigator, whether it is our processes (based on the all-important six-step financial planning process), the structure of the organisation or, most important of all, our people.

**WHAT ACCOLADES AND AWARDS HAS THE FIRM PICKED UP IN RECENT TIMES?**

Most recently we were awarded Money Marketing Small Firm of the Year 2017.

This was particularly pleasing on a number of fronts: it was awarded following completion of a questionnaire on our processes and advice, and attending a panel of sector experts, who put all the firms through their paces; the award was national, which is a tremendous reflection on the whole team and business; and the strength of the competition.

**WHAT SORT OF BUSINESS IS IT AND WHAT SERVICES DOES IT OFFER? WHAT'S YOUR USP?**

We are unashamedly a holistic financial planning business. If you want us simply to look after your investments to get the best return, please don't call us. Our belief is that holistic financial planning is based on the context that only a lifetime cashflow model can provide. It gives us a context in which we can give advice and, just as importantly, gives our clients a context in which they can make decisions. We are happy to serve any client to whom we think we can add value; however, there are a couple of groups of people that we have

a lot of experience with and to whom we specifically market.

Owner-managers of small and medium-sized businesses, typically one to five owners, are people with needs that are complex, and who do not have the expertise, the inclination or the time to deal with those needs themselves. We help them to understand what they want to get out of their business, now and in the future, and what they ultimately want to happen to the business. We deal with them while they are in business, and into and during retirement.

A subset of this is self-employed professionals, such as doctors, dentists, solicitors – again, all people that are income rich, but very time poor.

The second group is people who have suffered serious personal injury and have received, or are about to receive, compensation, and need to husband that money for the rest of their lives. They are neither technically nor emotionally equipped to deal with this. I have been working in this market since 2001 and I

find these clients some of the most rewarding to deal with.

### **HOW DID YOU GET INTO FINANCIAL PLANNING?**

By accident, like most people of my generation. A salesperson I knew tried to sell me life cover, but at the time my wife and I were really struggling financially and career-wise. The salesperson encouraged me to speak to his boss, who offered me a job as financial consultant with a life insurance company. Although I was thrown in at the deep end (this was 1994, after all), I was fortunate enough to receive good on-the-job training, and developed the conviction that the client always comes first, that has stuck with me throughout my career.

Early on in my career in financial services I worked out that one of the keys to success was technical expertise, and a few years into that journey I heard Nick Cann speak at an event in Belfast. Following that, I undertook the CFP certification case study and (a) passed first time and (b) had the ‘lightbulb’ moment that most people have when they go through the CFP certification process.

### **WHAT'S THE BEST THING ABOUT BEING AT A FINANCIAL PLANNING FIRM?**

I genuinely get a kick out of making a difference to people's lives. For example, we are working with a young man who, a few years ago, was attacked outside a pub and left for dead. He is wheelchair-bound, and can't cope with meetings lasting longer than about 45 minutes because of his brain injuries. He is about to be awarded a sum of money that is beyond his comprehension.

Using cashflow modelling to help him to understand that he needs every penny of that huge sum to rebuild his life in the way that he wants; protecting it against the state and against predatory ‘friends’ and relatives; helping him understand that inflation is his enemy, but that he is going to be OK – watching the lights come on in his eyes, is priceless.

### **WHAT DOES A TYPICAL DAY LOOK LIKE?**

I'm at my desk around 8am, and begin by creating a ‘to do’ list for the day. I keep emails to a minimum, aiming to clean them out first thing in the morning, at lunchtime and at the end of the day.

At 9.30am we have a team ‘stand-up’ – five or ten minutes when we review



**DAVID CROZIER CFP™ CHARTERED MCSI has been giving financial advice since 1994, and launched Navigator Financial Planning in 2004. He was the first fee-based financial planner in Northern Ireland and the first CFP™ professional in the Province.**

As a result, he has all the right experience and qualifications, and a client base made up of people who are confident in his technical expertise, especially in the areas of inheritance tax and pensions.

David is a former NI branch chair of the IFP, and a founding member of the Evidence Based Investment Solutions group. If you want to know where he is on a fine evening or weekend, the answer is usually fishing or sailing. He has a lifelong interest in photography (even if he isn't very good at it) and is an avid reader: fiction of all sorts; history; the Bible.

yesterday's activities and make sure nothing falls through the cracks. It's called a stand-up, because if you sit down, it will take more than five minutes! Fridays are extended into a half-hour team meeting, reviewing achievements, calendars and upcoming workloads and progress on specific projects and key metrics.

I could be doing any number of things during the rest of the day: client meetings; following up said meetings; professional connection meetings; helping staff with technical queries; out of sequence calls or emails to clients; writing marketing material – any or all of the above.

### **WHAT ARE YOUR KEY TIPS FOR OTHER PLANNERS?**

- ▶ We all need to get better at demonstrating to clients why we continue to offer value for money. Direct-to-consumer offerings are on their way, and will take a significant share of our market.
- ▶ Do as you would be done by. Do you have a financial plan? Preferably created by another financial planner and paid for? If you don't recognise the value of financial planning, clients and prospects will have trouble believing you.
- ▶ As a subheading to that, do you have an exit plan? What numbers are you putting in your plan for the value of your business and when? And if you don't have a plan, where are you getting those numbers from?
- ▶ Education: if you are not trained to a high level, how are you going to stand in the same rank as a solicitor or accountant, who will always be second-guessing your advice? ●

// I GENUINELY GET A KICK OUT OF MAKING A DIFFERENCE TO PEOPLE'S LIVES //

# On the Fury Road with Butch the big black Camaro

TIM BOLES' CHEVROLET CAMARO HAS OUTPACED RACING MEGASTARS AND APPEARED IN *MAD MAX: FURY ROAD*. **LORA BENSON** REPORTS

There are few of us who could claim to have escaped a burning car, but Tim Boles, Chartered FCSI, managing director at Equilibrium Pensions on the Isle of Man, is one of the exceptions. Combine this with the fact that it is a risk he faces when taking part in his sport of choice, motor racing, and we can determine that here is a CISI member who likes to live fast and furiously.

Tim appears to have motor racing in his blood. He is related to Tony Rolt, the Formula 1 British racing driver, soldier and engineer who, at his death in 2008, was the longest-surviving participant of the first ever World Championship Grand Prix at Silverstone in 1950.

Having grown up in the Highlands of Scotland, Tim first learnt to drive Jeeps on his father's farm at the age of nine, on 14 miles of private road. He competed in the Welsh Hill Rally in a Jeep CJ two weeks after gaining a driving licence at age 17 in 1977.

He was educated at Eton, and joined Sedgwick in the City as part of a graduate fast track trainee programme in 1986, after completing business studies at Westminster

University. In the 1980s Tim joined Gardner Mountain & Capel Cure Underwriting Agencies, being appointed a director and compliance officer in 1990. It was during this time that he founded Everitt Boles Motorsport Insurance Management, in addition to the Classic Camaro Club UK. For those of us unfamiliar with a Classic Camaro, it is a Chevrolet Camaro – an American automobile which first went on sale on 29 September 1966 for the 1967 model year and was designed as a competing model to the Ford Mustang.

Apart from the Jeep CJ, Tim's entire motor racing career has been founded upon one car: 'Butch', the black 1968 Chevrolet Camaro which he has raced since 1990, in countries including South Africa, the US and the Isle of Man.

He returned to motor racing in the 1990s, competing in the Aston Martin Owners Club events with wins at Brands Hatch in Kent; Croft Circuit in North Yorkshire; Castle Combe in Wiltshire; and the Manx Classic in the Isle of Man, which he won on three occasions.

But the biggest race he has ever entered, and won, was at Killarney in Cape Town,

South Africa in 2009. Tim, aka 'The Manxman', raced against South African star Sarel van der Merwe, aka 'Supervan', with 10,000 spectators and 400 other competitors. In a fascinating YouTube clip of the race ('Supervan vs The Manxman Wars'), Tim beats Sarel by 0.4 of a second.

## Star car

Tim's beloved Butch became an unlikely star after it appeared in *Mad Max: Fury Road* in 2015. Tim explains in an interview on Manx Radio: "I received this email out of the blue from a guy saying that they'd heard Butch's exhaust and that he thought it sounded very good. He said he would like to tape record the car. So they set a date and three of them turned up. They put 15 microphones all around the car and began recording. They asked me to sign a waiver, indicating there would be a big fine if I told anyone about the recording before the film came out." The sound became the sound of the hero's car in the movie, and the video game of the same name.

Tim loves racing as it "frees the mind of clutter and worries, as there is no room for anything else". His tips to those thinking of taking up this hobby would be to "keep calm and focused and avoid overdriving. Overdriving leads to trouble as well as slow lap times and degraded tyres." He's been in dangerous situations on a couple of occasions, usually involving a spinning car suddenly appearing in front of him and having to make a split-second decision to avoid crashing. He's also been in a Mercury Cougar when it was on fire and lived to tell the tale!

No doubt Mad Max fans out there will be watching keenly to spot Butch the Classic Chevrolet Camaro after reading this. ●



Contact [jane.playdon@cisi.org](mailto:jane.playdon@cisi.org) if you have a hobby you think will interest other CISI members. You will receive a £25 voucher if we publish your story.

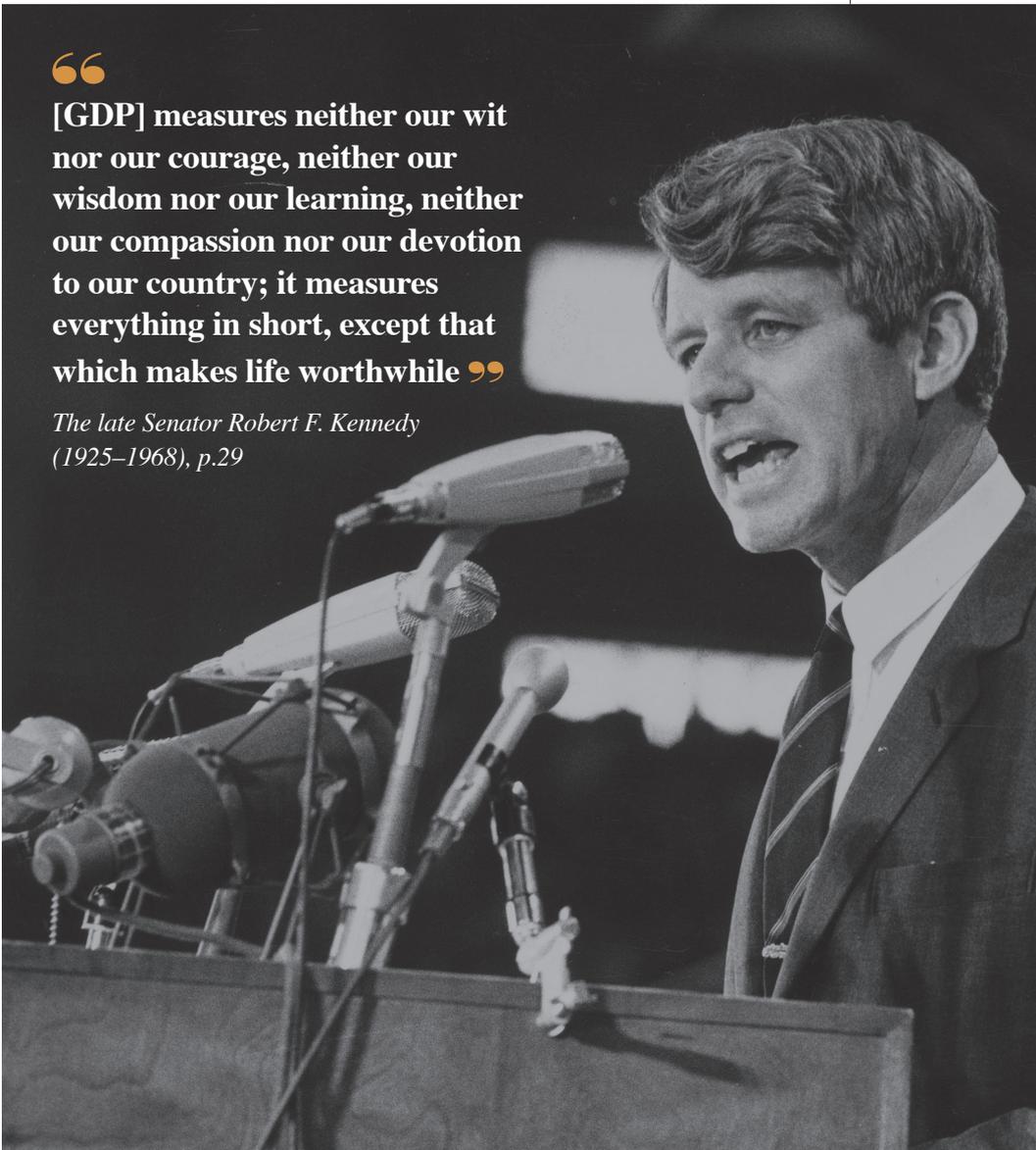


Tim Boles loves motor racing as it frees his mind of clutter and worries

“

**[GDP] measures neither our wit nor our courage, neither our wisdom nor our learning, neither our compassion nor our devotion to our country; it measures everything in short, except that which makes life worthwhile”**

*The late Senator Robert F. Kennedy  
(1925–1968), p.29*



**“Upton Sinclair 100 years ago said that it was difficult to get a man to understand something when his salary depended on not understanding it”**

*Anthony Hilton  
FCSI(Hon), p.16*

“

**We have come a long way, but not far enough. The system is safer, but not safe enough. Growth has rebounded, but is not shared enough”**

*Christine Lagarde, managing  
director, IMF, p.25*



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*In-depth analysis  
of the latest trends  
in the financial  
services sector*



**Anthony Hilton**  
FCSI(Hon)

FIRST  
PERSON

# Changes ahead for private equity

AFTER A DECADE OF GROWTH, THE PRIVATE EQUITY SECTOR SHOULD BRACE ITSELF FOR A CORRECTION

## “ Private equity has changed in the ten years since the financial crisis.

There has been a growth of scale. The big have become much bigger. Blackstone, for example, is some 20 times larger than it was in 2005.

This follows the trend elsewhere in asset management: the big become vast; the small operate as boutiques; the medium are neither one thing nor the other.

Blackstone, Apollo, CVC, Carlyle and a few others now account for roughly 50% of assets; the other 50% is spread between hundreds of other firms.

The medium firms have either done well or gone out of business. But even the good ones are heading for a much tougher time. Many will struggle to keep up when the cycle turns.

Investors are similarly more discerning. Pension funds and others are moving assets to the big players and cutting out small to medium ones. The mega funds are choosier, too, in whom they will accept. The business is maturing and with it comes lower returns for less risk.

It is also true that firms are not just private equity anymore; there is other stuff too – particularly credit, real estate and energy. Private equity titans have launched long-term funds – something they never used to do. They talk of great businesses that they want to own for a long time, and accept that this will mean a lower rate of risk and return. Again, this is quite different from traditional private equity. Blackstone’s recent stake in the former Reuters financial business for some £20bn is a

case in point. There seems to be no intention of selling this any time soon.

### External challenges

Equity markets are shrinking. The buyback market in the US over the past ten years has been greater, at US\$5tn, than the amount of quantitative easing by the Federal Reserve. In addition, there is a shortage of initial public offerings. Market capitalisation measures show the markets are rising, but this is from fewer and fewer companies. So private equity players have found it progressively more difficult to find companies to buy out.

Tencent, Alibaba and other Chinese players are buying stakes in promising technology companies, not just in China, but wherever they are allowed to go. This again makes it more difficult for private equity players to get a look in.

Metrics are stretched. Markets are high – private equity should be getting out. Instead, they have large funds that they cannot deploy. They have the firepower,

but not the fire. Globally, half the deals have a multiple of 11 times EBITDA, which is as much as in 2007. Covenant light loans are commonplace.

Leverage is back with a vengeance. It has the makings of a meltdown.

Finally, the sector still suffers from academics and others who do not believe the returns are worth the fees. And private equity still finds it too hard to say what those are.

“ The sector still suffers from academics who do not believe the returns are worth the fees ”

The issue here is less one of shortage of funds because of Brexit, so much as shortage because of a bear market.

Of course, it is not there yet, but two quotes seem apposite.

Upton Sinclair, the American writer, 100 years ago said that it was difficult to get a man to understand something when his salary depended on not understanding it.

The psychologist Daniel Kahneman says, when something goes wrong, people first of all don’t know what to do and run around like headless chickens. But they then quickly embrace the change, saying it was always going to happen, so they are not surprised. Hindsight is a wonderful thing because in effect it means they did not see what was going to happen, but they think they did.

### The hindsight problem

The 2008 crash was like this. People did not see it coming, but then they accepted it and that it was inevitable. And this makes executives far more bullish than they should be, because they rationalise the future as being a continuation of the past, rather than what it should be, which is an area fraught with uncertainty.

So, this is a sector that is in good health. But the trouble is that private equity people see what they want to see. They see markets that are very fully valued, but they don’t see that as a reason for not investing.

It is not just private equity; it is almost everyone in markets. But private equity has to live with the downturns much more. Like everyone else, I don’t know when this will be, but I do believe it will be a much smaller private equity sector that comes through it. ●

BANKS ARE FURTHER ALONG THEIR DIGITAL JOURNEY THAN WEALTH MANAGERS, BUT THEY ARE STRUGGLING TO GENERATE RETURNS ON DIGITAL INVESTMENTS. WEALTH MANAGERS' MORE CAUTIOUS APPROACH MIGHT BE PAYING OFF. **PAUL BRYANT** REPORTS

# Who's solving the digital puzzle in financial services?

**D**igitalisation', defined by research house Gartner as "the use of digital technologies to change a business model and provide new revenue and value-producing opportunities", has been mooted as a massive opportunity for financial services companies.

It is more advanced than 'digitisation', which, according to Gartner, "takes an analogue process and changes it to a digital form without any different-in-kind changes to the process itself".

Global management consultancy Boston Consulting Group (BCG), in its 2017 report titled *Why aren't banks getting more from digital?* says retail banks that digitalise can achieve a 20% revenue boost and a 30% reduction in expenses. It cites an example of a North American bank that achieved this level of cost reduction by redesigning and digitalising its credit lending function. By automating processes – such as applicants submitting information electronically that then feeds directly into back office systems – the time from application to funding was halved, client satisfaction was boosted, and the number of exceptions requiring manual intervention reduced.

For wealth managers, BCG's *Global wealth 2018: seizing the analytics advantage* report estimates that digitalisation has the potential to grow the top line by 15%–30% and drive efficiency gains of 10%–15%.

It is also key to protecting existing business. In a November 2017 research presentation on attracting and retaining wealth management clients, Compeer finds that more than 50% of wealth management clients who consider websites, client portals and mobile applications in need of significant improvements are likely to look for another provider if changes are not made.

## Banks' digital difficulties

Most banks have been struggling to make money from their digital investments. In a July 2018 paper on banks and the 'digital flywheel', McKinsey reports that 21% of financial institutions say their digital investments are generating negative returns. Nearly 50% say returns are below their cost of capital, which McKinsey says is around 10% for banks.

Tim Jones CBE, former CEO of retail banking at NatWest, offers an explanation: "The blunt reality is that for an incumbent bank, the vast majority of the most valuable customers are older. And many of them just don't care about digital. The 'silver surfers' – the older generation that do embrace digital – are often in the minority. So, because the majority of valuable customers prefer the way things are done now, like using telephones and paper forms, banks have to keep the infrastructure to service them, and digital investments end up adding to banks' costs. And these investments don't bring in much additional revenue either. Digital banking services are more attractive to a younger demographic, and younger people generally have less money than older people. For a bank, people with less money are less profitable. Therefore, banks' digital investments lose them money!"

While these new digital customers will eventually become the most valuable customers of a bank, and it will make sense to remove the old infrastructure then, that point can be 20 to 30 years away.

BCG's *Why aren't banks getting more from digital?* report flags difficulties with project execution: "In the majority of cases, implementation results are disappointing. The pace of delivery is slower than initially expected; it is difficult to scale digital

// FOR WEALTH MANAGERS, DIGITALISATION HAS THE POTENTIAL TO GROW THE TOP LINE BY 15%–30% //

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solutions across the bank ... or the impact on the bottom line is insufficient.”

It finds that the number one cause of digital failure in banking is related to the complexity of dealing with legacy IT systems; followed by data architecture problems; key talent gaps; and organisational resistance to change.

Tim can testify to some of these issues: “It is often not a case of migrating from a single legacy system. Older banks will typically have separate technology platforms for retail banking, credit cards, mortgages and for other products. So, it’s absolutely heroic to think that you’re going to take all of that functionality and put it on a single, more modern platform, without major difficulties.

“It’s also true that there is normally very significant resistance to change. Digital transformations usually reduce employee numbers at a bank and turkeys don’t vote for Christmas. This is a very tricky management problem, but the way these barriers are overcome is to appoint the right lead executive team, and to make it very clear to everyone that the change is simply not negotiable.”

Banks’ record on appointing the right leadership teams is not a good one, however. A 2015 survey by Accenture, *Bridging the technology gap in financial services boardrooms*, finds that only 6% of board members and 3% of CEOs in leading banks have professional technology backgrounds, while 43% of banks don’t have any board members with professional technology backgrounds. In a recent blog – ‘Ten chairs: How to change the bank’ – financial services

ILLUSTRATION: ISTOCK



commentator Chris Skinner says not much has changed since then.

McKinsey has identified common characteristics of banks generating the highest returns from digital investments.

First, they were not treated as ‘one-off’ projects, but as a continuous, ongoing transformation of the organisation.

Second, once these banks implemented a digital project, they would move quickly to capture productivity gains and then reinvest the savings into the next project. If a new app moved some customer activity from branches to online, the number of tellers or branches would be cut, freeing up cash. These banks had overcome, or at least partially overcome, the cost duplication problem flagged by Tim.

Third, they had a bigger focus than digital underperformers on productivity and cost reduction. For example, if a new app did migrate more customers online, the bank would move quickly to sign them up for digital-only statements, reducing paper statement spend.

**Wealth managers lagging in digital**

Banks and insurers are generally more advanced than wealth managers in their digital journeys. McKinsey senior partner and ‘Digital McKinsey’ global leader Paul Willmott says that the highest proportion of digital sales in financial services takes place in car insurance, followed by credit cards, home insurance, savings accounts, then current accounts. Wealth management, excluding online stockbroking, has one of the lowest digital penetrations.

In the UK, the number of people purchasing car insurance online has now reached around 23 million, according to Finaccord, compared to only 2.5 million people using online-only investment platforms, according to FCA figures. In banking, no direct comparative data to these online-only purchases exists, but the use of digital is very advanced, with around 37 million people managing their current accounts online, according to UK Finance.

Much of this difference has to do with the length of time these financial products have been available online. “The simpler and more commoditised nature of some banking and insurance products made it easier to take them online earlier,” says Paul. “And with any shift in technology, very little takes place in the short term, but in the medium term, an awful lot happens. If you look at retail banking, it’s taken 10–15 years to reach today’s levels of 50%–60% sales online. In comparison,

// THE NUMBER ONE CAUSE OF DIGITAL FAILURE IN BANKING IS RELATED TO THE COMPLEXITY OF DEALING WITH LEGACY IT SYSTEMS //

a product like robo-advice only really got going a few years ago.”

Another factor is that wealth is skewed towards older demographic segments, where the digital take-up is lower. But Paul says that once you digitise the sales channels, and customers start moving online in bigger numbers, it accelerates the move to a more digitally-advanced back office.

### Keeping the ‘human touch’

Wealth managers have started to play catch up. At the upper end of the market, the Coutts Invest digital platform was launched in April 2017. Nick Johnson, head of digital investing at Coutts and NatWest, says that clients can view their portfolio details online; receive digital reminders of their regular and more straightforward financial transactions; and execute a simple online transaction without seeing, and incurring the costs of, a wealth manager. He says: “In 2018, about 20% of our new investment assets into the group will come from digital channels, and we’re only at the start of the journey.”

Nick acknowledges the move to digital is not for everyone and some will expect a personal service, which is still available.

Gareth Johnson MCSI, head of digital channels and investment solutions at Brewin Dolphin, says their approach to digital has been to design initiatives around customer needs, resulting in a non-advised, online only investment channel, Brewin Portfolio Services (BPS), and a ‘hybrid’ channel, which is much larger.

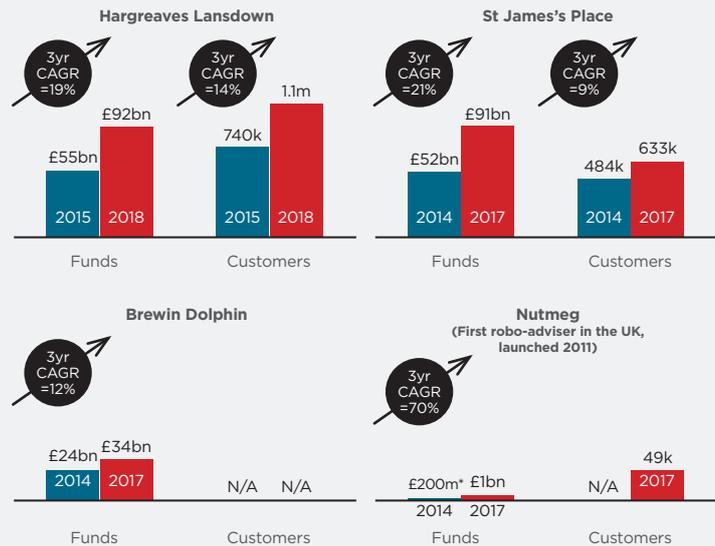
He says BPS allows the company to service customers at lower cost and target customers with relatively small investment pots (minimum £10,000). BPS now makes up £0.1bn funds under management.

But Gareth adds: “We find that people with more complex needs want more human interaction. A client with £1m invested is thinking about their own future, as well as their children and grandchildren, and that requires a level of planning.”

### Cost cutting

Sometimes digitalisation is about efficiency. Philippa Fielding, Chartered FCSI, manager of capital markets at Accenture Consulting, says the cost savings potential is huge: “We have seen the move to digital reduce wealth managers’ total costs by as much as 30%. In areas such as digital onboarding and client profiling, there are cases where the amount of ‘manual labour’ has been reduced from over seven hours to as little as ten minutes. This will involve automating things like anti-money laundering checks and risk profiling.”

## RESPECTABLE GROWTH FOR INCUMBENT WEALTH MANAGERS; LARGEST ROBO-ADVISER STILL VERY SMALL



Source: Company annual reports and websites, \* = estimate by Numis Securities  
 Funds = funds under management or administration  
 CAGR = compound annual growth rate

Wealth managers’ more cautious approach to digitalisation appears to have gone down well with investors and clients. The three largest stand-alone wealth managers in the UK have outperformed the banking index over a three-year period, shown respectable growth, and have hardly been impacted by new ‘robo-attackers’ (see above).

But wealth managers will need to keep advancing their digital offerings as competition from online-only and hybrid channels increases and consumers get more comfortable with digitalisation.

Penetration of robo-advisers is still very low and there have been some high-profile failures, such as UBS launching its SmartWealth platform in March 2017 and then closing it to new investors and selling it 18 months later. Despite this, it’s probably too early to write off the robo-threat. McKinsey’s Paul says because of the technological shift for consumers being in its infancy, it is “misguided” to say that robo-advice is a failure.

Hybrid competition is also intensifying. In 2017, Aviva acquired a majority stake in robo-adviser Wealthify, Barclays launched its Smart Investor platform and Investec launched its online platform Click and Invest. These are credible online offerings, with powerful wealth management businesses to build on. ●



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THE FINANCIAL SERVICES SECTOR HAS UNDERGONE A REGULATORY TRANSFORMATION SINCE THE 2008 FINANCIAL CRISIS. HOW HAVE BANKS AND CONSUMERS BEEN AFFECTED BY THE CHANGES? **VICTOR SMART** REPORTS

# Where are we now?

A decade ago, the West's financial system was teetering on the edge of an abyss. Crisis measures on an unprecedented scale, mainly from central banks, have brought back stability. Yet even now a return to the conditions before the crisis remains a distant prospect: interest rates are at ultra-low levels and quantitative easing has left us burdened with excessive public sector debt. GDP growth and incomes will take years to recover lost ground.

Meanwhile, among the public there remains a widespread distrust of banking (see chart on page 24 on 'Trust in industry sectors, five-year trends') and a frustration that individual bankers were never properly called to account.

The crisis showed how interconnected the global banking system was. As institutions as various as Northern Rock, Lehman Brothers and AIG tottered, the US and European authorities acted on a scale never seen before to stop the dominoes falling. They bailed out or nationalised banks; provided massive liquidity and monetary stimulus to the entire dollar-based financial system, to Europe and the emerging markets beyond; and in some cases introduced negative interest rates. With hindsight, the strategy was necessary and it worked. The US stock market hit historic highs in 2018 and the markets have been comparatively calm. In 2017, six of the seven lowest readings for volatility on record were measured by VIX, the 'fear index'.

But there have been massive, and often unforeseeable, side effects to the protracted period of emergency measures. The banking crash morphed into a highly-damaging eurozone crisis. This negatively affected the levels of trust citizens had in their political leaders. In

Portugal, Italy, Spain and above all Greece, the EU's democratic legitimacy was stretched to breaking point. Moreover, governments' strenuous response to the crisis has helped inflate the value of assets like equities and property, which are more often owned by the wealthy. This has increased the public's worries about inequality and whether the system distributes wealth fairly. Meanwhile, a decade on, we are still overly dependent on liquidity and leverage – rather than improving productivity – to deliver growth; only this time it is central banks that are supplying the cash to the financial system. Hence levels of risk remain uncomfortably high.

## The effect on banks

In a report from January 2018, called *Structural changes in banking after the crisis*, the Bank for International Settlements (BIS) summarised some of the structural impacts on financial services.

First, the biggest banks have grown even larger. America's top five banks control around 47% of banking assets, up from 44% in 2007. In the West, some banks have shifted away from trading to less complex activities, such as commercial banking and wealth management, with an increased reliance on more stable funding sources, such as customer deposits.

Banks' profitability has declined, but their resilience has increased, and they have built up better capital and liquidity buffers, in part to meet stress-test standards imposed by regulators. On the regulatory front, a new class of globally systemically important banks has been designated – currently a grouping of 30 banks that hold more than one-third of global banking assets. These face higher capital buffers and additional disclosure requirements.

&gt;&gt;

A DECADE OF CHANGE

2008

Black = Sector actions  
Blue = Government interventions  
Red = Regulatory changes  
Green = Effect on individuals

September

Wall Street bank Lehman Brothers files for bankruptcy

Lloyds TSB takes over Britain's biggest mortgage lender, Halifax Bank of Scotland (HBOS), in £12bn deal



UK government takes control of Bradford & Bingley's £50bn of mortgages and loans



Irish government guarantees consumer deposits in the country's main banks for two years

October

Iceland's government takes control of Landsbanki, the country's second largest bank



Bank of England (BoE) cuts interest rate by 0.5% to 4.5% as part of a coordinated global attempt to ease crisis

US President Bush signs the Troubled Asset Relief Program into law



UK government unveils £50bn plan to part-nationalise major UK banks and pump billions more into helping ailing money markets

UK announces a £37bn rescue package for Royal Bank of Scotland (RBS), Lloyds TSB and HBOS

IMF approves a US\$2.1bn loan for Iceland after the country's banking system collapses

UK government takes a 58% stake in RBS for £15bn

2009

January

Irish government says it is to nationalise the Anglo Irish Bank

US government provides Bank of America with US\$20bn to help it with losses



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BIS also notes the new role of shadow banking. The financial crisis has increased the competition faced by traditional banks from shadow banking as regulators seek to make banking more transparent and safer. Their assets were up from US\$28tn a decade ago to US\$45tn at the end of 2016, controlling 13% of the world's financial assets.

Finally, there has been a relative shift in power: banks in Australia, Canada and Sweden fared better and did not need government support and emerging markets were insulated from the turmoil by their domestic focus. China's banking sector has continued its rise. Even so, US banks have come to overshadow their European counterparts.

One further noteworthy issue is bankers' bonuses. These tumbled after the financial crisis, and while they are on the rise again in some areas, they have not returned to their peak (see chart, right). The average bonus for a New York City securities sector employee peaked in 2006 at just under US\$200,000, nearly halved in the next two years and by 2016 steadied at just below US\$150,000.

**Regulatory backlash**

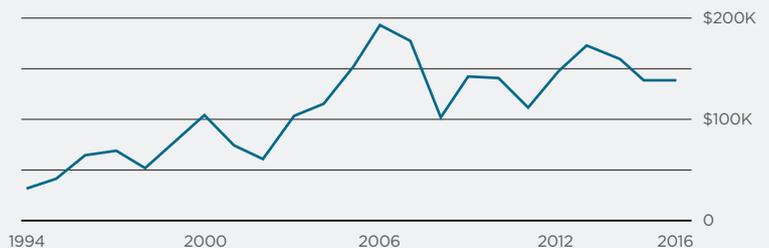
Given the scale of the crisis, a regulatory backlash was inevitable. In the US, the Dodd-Frank Act passed in 2010, intended to provide rigorous standards to protect

the economy and American consumers, investors and businesses. Its advocates claimed it would end taxpayer-funded bailouts of financial institutions. Similarly, the US Foreign Account Tax Compliance Act required all foreign financial institutions to report on the non-US accounts held by their American customers and green card holders – or face hefty withholding payments.

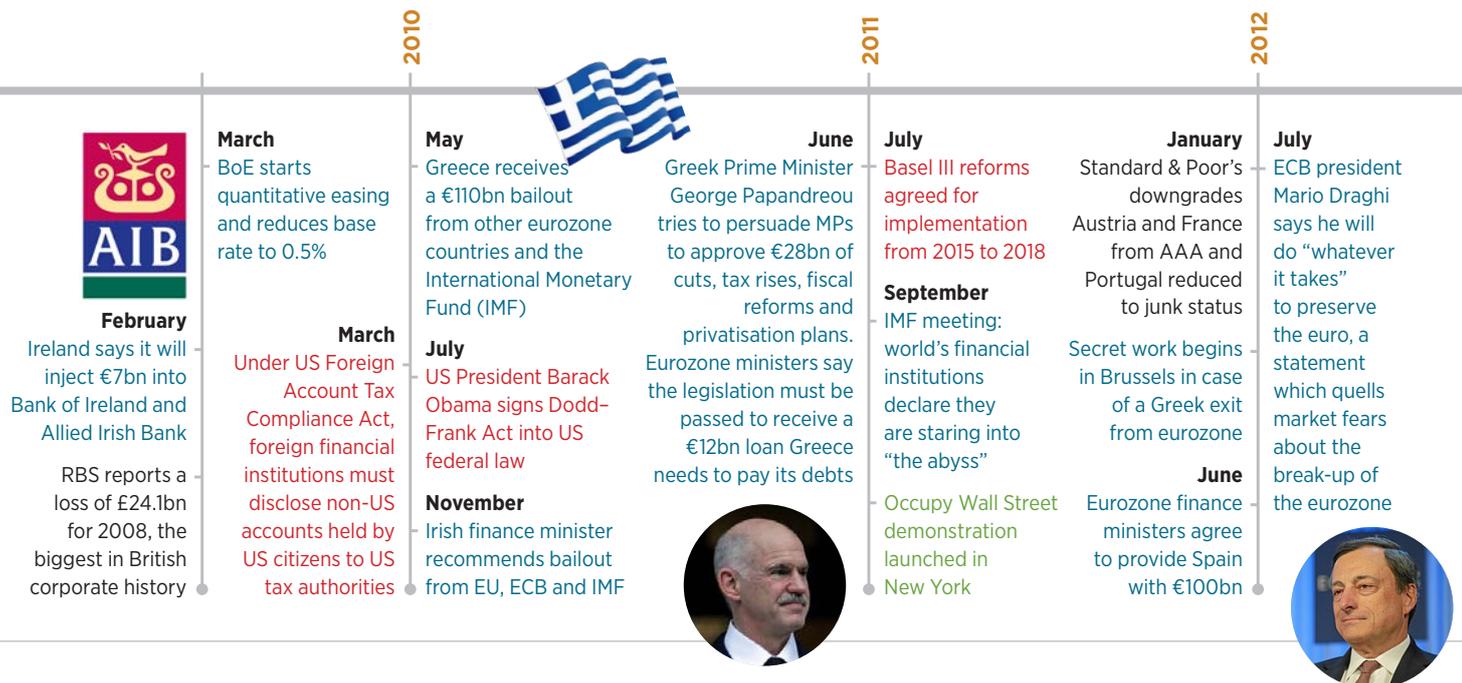
Many in the financial sector voiced concerns about the heavy-handed new rules, costly to banks. In June 2015, Christopher Bond, Chartered MCSI, editor of the CISI's 'Regulatory update', previously a separate publication called *Change*, said in *The Review* (see

**WALL STREET BONUSES STILL DOWN FROM PEAK**

Average annual bonus for New York City securities sector employees



Source: New York Office of the State Comptroller



*cisi.org/risingtide*): "The pendulum tightening global regulation has swung very far and may need to be recalibrated so that financial services can perform its true role of encouraging businesses to expand and creating world growth."

This was borne out by research claiming that investment banks now spend US\$300,000 a year per client-facing employee on compliance, risk and finance, up by a half since a decade ago.

The tide has now begun to turn against the tougher regulatory regime – something that Christopher predicted in September 2015 in an article in *Change*, titled 'The pendulum swings – a sunnier climate for financial services regulation?' In it, he suggests that then chancellor George Osborne's Mansion House speech, which called for the financial services sector to be part of the solution, and the Financial Stability Board's decision not to make asset managers globally systemically important were signs that financial regulation reforms had reached a tipping point.

Under President Trump, Congress began to roll back the Dodd-Frank Act in June 2017. The Act will no longer apply to banks with less than US\$250bn in assets and the Volcker Rule prohibitions on proprietary trading done by banks with less than US\$10bn in assets could disappear.

Meanwhile the UK regulators have taken a different tack: they have blazed the trail

in trying to make individuals accountable for banking missteps. The UK's Senior Managers and Certification Regime (SMCR) was introduced in 2016 for banks and other deposit takers; the rules were rolled out to insurance companies in December 2018, and the remaining 55,000 or so firms that make up the wider UK financial services sector from December 2019. The rules are most stringent for the largest organisations and will be applied in a less onerous manner to the rest. In addition, the retail and warehouse sides of banking are being separated: the UK Banking Reform Act 2012 will ring-fence retail banking from investment banking from January 2019 to safeguard customers.

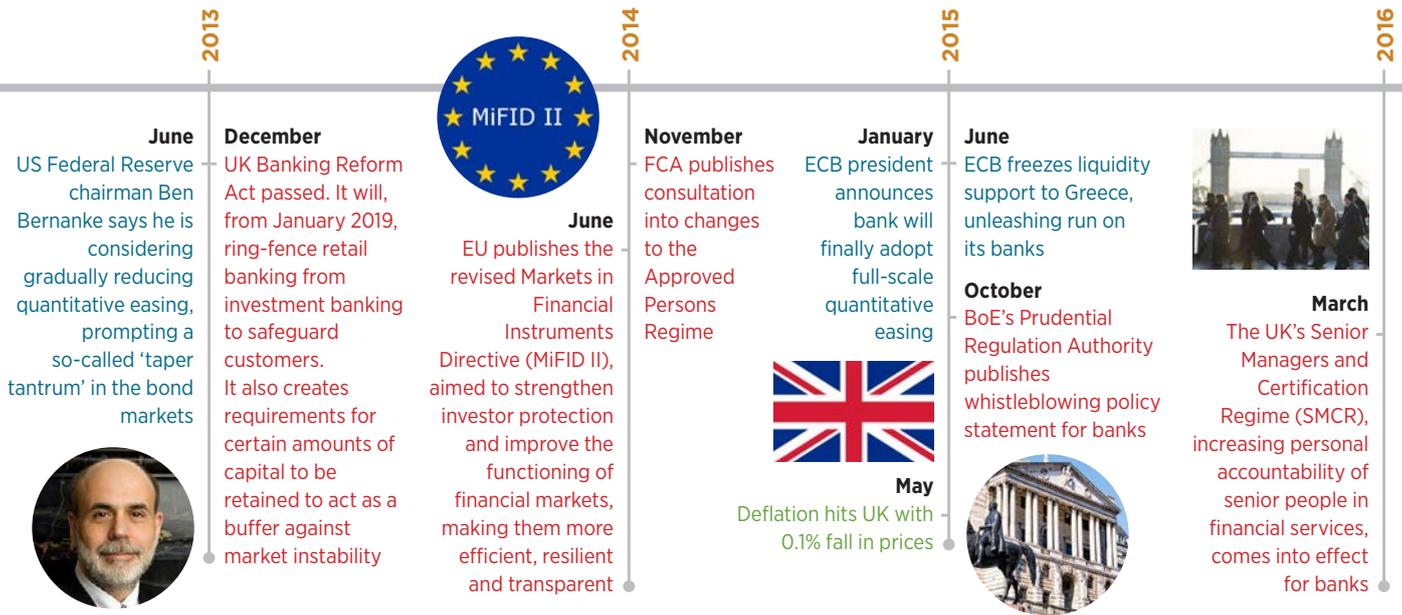
The regulatory activity has boosted workloads for compliance teams. In an online survey of CISI members, conducted in April 2018, 93% of respondents said the rollout of regulation had become more frequent than in 2015.

#### Holding individuals to account

These moves attempt to address one of the oft-heard complaints in the wake of the financial meltdown – that while institutions were hammered for malfeasance, individual bankers were not. In the UK, there was public outrage that former Royal Bank of Scotland chief executive Fred Goodwin never faced action by the regulators for mismanaging the bank to

// THE PENDULUM TIGHTENING GLOBAL REGULATION HAS SWUNG VERY FAR AND MAY NEED TO BE RECALIBRATED //

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>> such an extent that it required a £45bn taxpayer bailout. In fact, only one banker, Peter Cummings from Halifax Bank of Scotland, has ever been formally penalised by regulators as a result of the crisis.

Under SMCR, firms must explicitly record which individuals among their most senior management team are responsible for each specific area of the business, thereby making it potentially easier to take regulatory action against them.

According to Katharine Harle, senior associate at law firm Dentons, the original plan included a presumption of responsibility, putting the onus on the designated individual to show that they were not to blame for failings in their area. She says: "The overall aim is that the individuals involved in running firms have some skin in the game. But the message from the regulators has changed more recently and the FCA has made it clear it does not see this as an enforcement-led regime."

So far, the only individual penalised under the SMCR regime is Barclays' chief executive Jes Staley, who was fined £640,000 for trying to uncover the identity of a whistleblower.

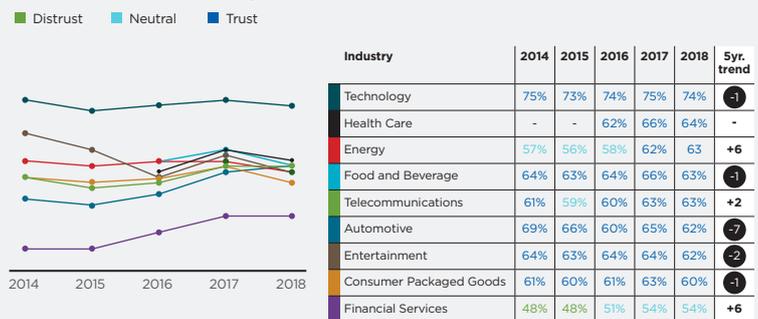
Prem Griffith, a former FCA associate, now at regulatory consultancy Bovill, comments: "It is disappointing that in two and a half years, the sole example of the regulators holding a senior banking

executive to account is a somewhat underwhelming slap on the wrist for the Barclays chief executive. The SMCR's success is largely predicated on the perception that regulators are readily able to take action against senior individuals for serious negligence or incompetence. In the absence of that, the deterrence factor is rapidly diminishing."

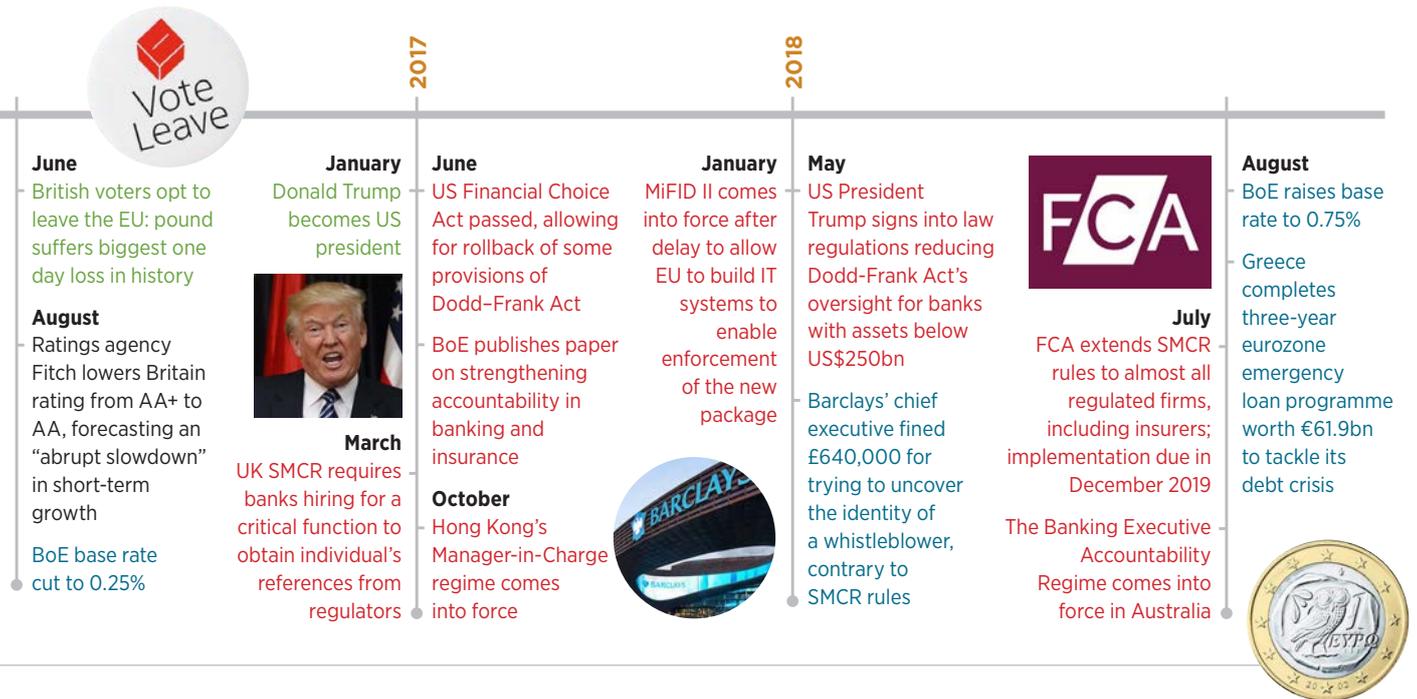
Despite scepticism about whether such regulation has teeth, Australia has now introduced similar procedures under the Banking Executive Accountability Regime. Hong Kong has introduced a Manager-in-Charge regime and Singapore is consulting on a similar approach.

### TRUST IN INDUSTRY SECTORS, FIVE-YEAR TRENDS

Trust in each sector, and change from 2014 to 2018



Source: 2018 Edelman Trust Barometer



Some senior bankers believe rebuilding public trust will dominate the sector's agenda for another decade. That will not be easy, given the sullied reputation of the sector and the lasting damage done to the economy.

#### Dented consumer trust returning

Public trust in financial services has been woefully trailing that of other sectors, although a recent Edelman survey shows that trust in the sector has risen to 54%, up six points since 2014. By contrast, the technology sector has stood at around 74% for some time and the energy sector has risen by 6% to 66% over the period (see chart, left).

There is still a long way to go, however. Lack of wage growth and increasing levels of personal debt have converged to give consumers a raw deal from a crisis not of their own making.

An analysis by the Institute for Fiscal Studies shows that, on average, in the UK people's real annual wages are £800 lower than at the time of the crash. Those aged between 30 and 39 now are earning £2,100 a year less than people of the same age group in 2008. Inflation looks set to remain tame but there are only tentative indications that real rises in take-home wages are finally materialising, since productivity gains in the UK are poor. Nominal wage growth in other advanced economies has been

sluggish, despite tight labour markets.

Record lows for interest rates are lasting far longer than most expected. Of course, borrowers such as mortgage holders have benefited, although until recently the steady rise in the cost of homes in the UK has tended to offset this.

Meanwhile, personal debt has reached record levels in the UK, with £1.38tn owed. Policymakers believe educating future consumers about how to use money sensibly will help to eventually tackle this problem. Hence financial literacy has been part of the national curriculum in England since 2014. But an OECD report finds that the UK is below average when it comes to teaching the subject.

So, a decade on, we are not remotely near where we wanted to be at the end of the recovery cycle. Central banks have more or less exhausted their most extreme forms of support and are only hesitantly moving interest rates back towards traditional levels. The regulatory response has been patchy at best. And some figures involved in the crisis of a decade ago fear that, in the event of another crash, the world would be ill-equipped to cope, as there is now less trust among world leaders. As IMF managing director Christine Lagarde tweeted recently: "We have come a long way, but not far enough. The system is safer, but not safe enough. Growth has rebounded, but is not shared enough." ●



For more on lessons learnt in the wake of the financial crisis, read our article about the Edinburgh-based Library of Mistakes, pp.26-28



# Learning lessons

AN EDINBURGH-BASED LIBRARY CHARTING THE MISTAKES OF THE FINANCIAL SERVICES SECTOR IS A SALUTARY REMINDER THAT WE MUST LOOK TO THE PAST TO AVERT FUTURE CRISES. **MARTIN FLANAGAN** REPORTS

It is telling that ten years on from the financial crash, a ‘Library of Mistakes’ on the crisis – and on many centuries of financial history – is thriving. The charitable venture, based in Edinburgh, was founded in 2013 to promote the study of financial history by students, professionals and the general public. Russell Napier, CEO of the Didasko Education Company, set up the library with donations from Edinburgh’s investment community.

The library’s aim is to improve financial understanding “one mistake at a time”. In agreement with Einstein’s famous dictum that the sign of madness is to do the same wrong thing repeatedly and expect a different result, Russell says that “studying financial history may help to reduce financial madness”.

This includes exploring “human decision-making under uncertainty,” says Russell. He adds that, although the library’s books cover events back to ancient Greece, “the crash of 2008 has ensured a particular focus on banks. The financial crisis even had the Queen asking academics in 2008

why nobody saw it coming. People who read financial history did see it coming, but there are so few who do that it made little difference. But the crash helped. It has slowly shifted the way finance is taught”.

## Making progress

But has the financial services sector learnt the lessons of the near implosion of a decade ago? There are reasonable grounds for believing there has been progress, but we should caution against complacency.

One concern, say critics, is that a number of business schools have done little to update their curriculums to reflect the crash. An article in *The Review* ([cisi.org/universitychallenge](http://cisi.org/universitychallenge)) from April 2015 says many business schools are “clinging to an economic syllabus based on models that have been proven flawed” seven years after the crisis. Some business schools dispute this.

The London Business School (LBS) says that in economics it has always examined financial crises, how they happen and their impact, “but in the wake [of 2008] we extended this material, updated case

// THE LIBRARY’S AIM IS TO IMPROVE FINANCIAL UNDERSTANDING, “ONE MISTAKE AT A TIME” //

studies and also focused on new aspects”. This includes the global nature of the near-meltdown of banking, the role of sometimes esoteric collateralised debt obligations, the shadow banking system and remaining global instabilities. LBS says: “We have always taught an ethics and CSR [corporate social responsibility] course, but this was supplemented to become a more substantial course that also covered the broader government and social agenda around business issues and also included a substantial amount around regulation.”

The interconnectedness of the banking world has been identified as a key component of the financial disaster. Chris Higson, LBS’s faculty member overseeing its Masters in Finance programmes, introduced a Purpose of Finance course about the time of the 2015 article in *The Review* as a response to the 2008 fallout. Chris says: “We knew that one problem was the interrelatedness of financial institutions and the excessive complexity of financial contracts. We explicitly addressed there being too many steps in the supply chain.”

Mark Skilton, professor of practice in information systems and management at Warwick Business School, says he is always trying to modernise the curriculum. But he acknowledges that the continuing pace of change in financial risk means there is always an element of playing catch up. Mark has identified future risk challenges to banking business models that include artificial intelligence, automation, climate change, the political dynamics of populism, and issues to do with water in the next 20 years fuelling demographic disruption.

However, at the Library of Mistakes, Russell is sceptical of one suggestion made in *The Review* article – that even if recent graduates have learnt something different at university, it will not benefit financial services consumers because it will take them time to gain any internal influence.

He says: “It’s not the understanding and knowledge, but the incentives still being paid in the sector that are the problem. There has not been any material improvement here to avoid mistakes being made. A 25-year-old can come out of college with a degree, doctoral thesis, whatever, but it will mean nothing if the incentivisation (to potentially act improperly) does not change.”

### Ring-fencing retail banks

At one of the most tense times in the UK during the financial crisis, savers queued around the block at Northern Rock

branches, and Royal Bank of Scotland (RBS) cash machines came within hours of running out of money. In an effort to avert a rerun of this, the legal ‘ring-fencing’ of the core retail banking activities of the UK’s biggest banks from their riskier investment banks is one of the greatest comforts to banking customers. This must be accomplished by 1 January 2019. With the benefit of hindsight, it only seems due to the lengthy period of strong financial performance the banks enjoyed from the end of the 1990–92 recession, that ring-fencing was not adopted before the crash.

## // THE CONTINUING PACE OF CHANGE IN FINANCIAL RISK MEANS THERE IS ALWAYS AN ELEMENT OF PLAYING CATCH UP //

A tour around the Library of Mistakes relives the financial shocks of 2008 and other more ancient crises. There is a poster with ‘Greed and corporate failure’ on it; another billboard from the *London Evening Standard* with the headline ‘Britain’s £500bn bailout: special edition’ at the height of the latest financial crisis.

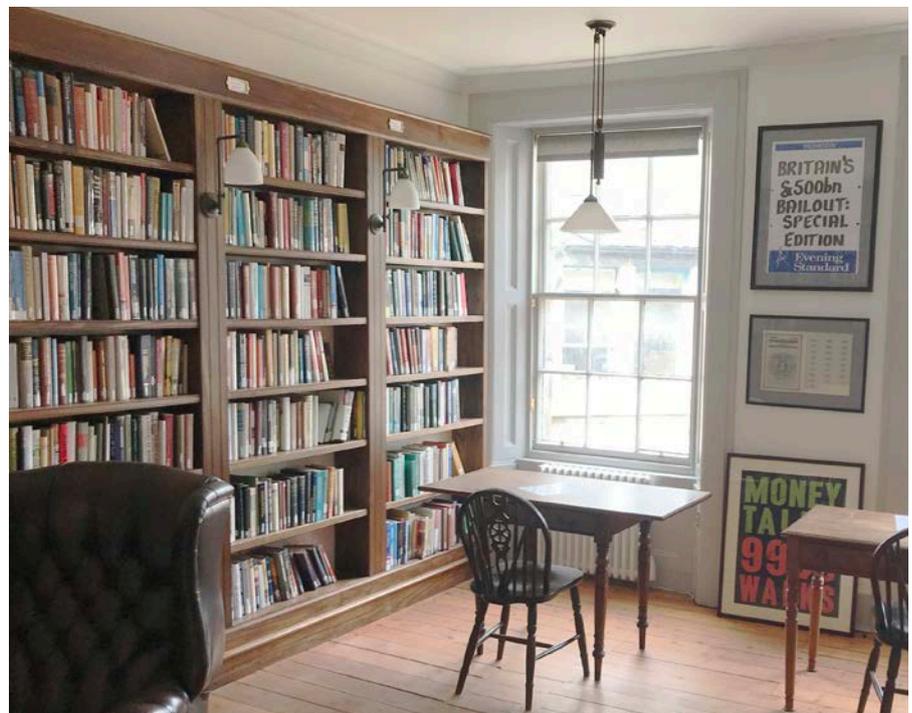
Russell namechecks the library’s exhibit *The big short* by Michael Lewis, a book that pinpoints the crux of the sub-prime

debacle and the fall of investment banking giants Lehman Brothers and Bear Stearns. “Lewis made clear it was a rerun of Hans Christian Andersen and the king having no clothes. Many bankers knew that at the time, but they had been incentivised not to pay attention,” he says. “It taught us the importance of liquidity in banking. Investors had thought they had liquid assets in mortgage-backed securities and they didn’t. There were no buyers.”

*A very English deceit*, by Malcolm Balen, meanwhile, is the library’s exhibit analysing the South Sea Bubble of the early 18th century – at first a highly profitable South Sea Company, sparking a torrent of flotations before ending in disaster for investors from leading politicians to chambermaids.

Russell says: “The South Sea Bubble shows us that in a stock market boom there are a spate of new issues, with many of the business models unproven. It came again in the dotcom boom of the early noughties, so you can draw your own conclusions on how much investors had learnt.”

Meanwhile, a lesson that has been learnt by the sector from the crash is the need for banks to be better capitalised. A key factor in 2007–2008 was their dependence on financial markets as those markets froze. Back then, RBS had a dizzying £2tn balance sheet, with a core tier one capital ratio – the cushion backing its loan book – of just over 4%. The rest is well known



– the biggest loss in UK corporate history and a tumble of the lender into taxpayer ownership. By contrast, under pressure from the Prudential Regulation Authority and increasingly severe ‘stress tests’ on their balance-sheet strength in extremely challenging hypothetical economic scenarios, the UK’s major banks have now all but achieved much more robust targeted capital ratios of 13%–14%.

Ian Gordon, banking analyst at Investec Securities, says: “They are all near enough there.” Asked what lessons the sector has learnt, he adds: “They have a more disciplined focus on products with regard to conduct and risk. And they have materially less appetite for high loan-to-value mortgages and commercial real estate lending.” Vigilance on misselling conduct remains vital, however.

### Moving towards transparency

Banks being under-capitalised in the latest crash has shades of another book in the Library of Mistakes: Mitchell Zuckoff’s *Ponzi’s scheme: the true story of a financial legend*. In Ponzi’s case, back in the 1920s, there was no real money in the first place. He could only pay apparently fantastic but illusory returns to investors by using new client money to pay the early investors.

The lesson, says Russell, was that a “vaguely plausible” investment offer – Ponzi was initially in international postage stamp arbitrage – can suck investors in, but that “if it sounds too good to be true, it is”. A warning sign was when newspapers of the time revealed that Ponzi refused to reveal his investment secrets.

Meanwhile, in July 2018, the FCA had the providers of fast-growing investment platforms in its crosshairs. The financial regulator said these distribution channels for retail investments sometimes had opaque structures and that there were wide variations in charges and penalties for exit, with “significant” barriers to switching providers that “limited the pressure on platforms to provide continued value for money”. A decade on from 2008 and there is a perennial concern that small investors can be placed at a disadvantage in an arcane, jargon-rich sector remains.

Also under the spotlight is crowdfunding, which facilitates investors lending to individuals or small businesses, or buying shares in unlisted companies. So far, the FCA has deemed crowdfunding a force for good. But it has called for transparency on charges, services and returns.

A more universal welcome since the crash is given to the new safeguards

afforded by the Senior Managers and Certification Regime, ushered in by the FCA in March 2016. It is difficult to argue that the new regime does not clarify lines of responsibility in the top echelons of banks, and gives regulators greater ability to hold senior individuals to account for wrongdoing. Banks have to annually certify their ‘material risk takers’ for fitness and propriety. There are new criminal sanctions for actions that cause a bank to fail.

In general, the banks believe they have demonstrated good faith and rigour in addressing their faults. A spokesman for UK Finance, the financial services trade association, says its members have undergone “unprecedented reform” covering capital, liquidity and structural reorganisation. “The financial services sector is now more resilient and with improved standards and strengthened personal accountability,” he says.

### A welcome sign

Learning from the past, not madly repeating it, is the recent furore when Barclays CEO Jes Staley attempted to use the bank’s internal mechanisms to identify a whistleblower in relation to the alleged behaviour of a senior colleague. Staley kept his job, but was publicly reprimanded by his employer, lost £500,000 of his bonus, while regulators fined him a total of £642,000.

For the crash truly to be consigned to history, it is likely this mixture of practical reforms, a ready available financial history, cultural change and continuing vigilance is a credible way forward. ●

// THE UK’S MAJOR BANKS HAVE NOW ALL BUT ACHIEVED MUCH MORE ROBUST TARGETED CAPITAL RATIOS OF 13%–14% //



THE POPULAR ECONOMIC CONCEPT FAILS TO TAKE THE NUANCES OF POST-INDUSTRIAL ECONOMIES INTO ACCOUNT, BUT ECONOMISTS THINK IT'S STILL THE BEST MEASURE THAT WE HAVE. **PHIL THORNTON** REPORTS

# Taking the P out of GDP?



**G**ross Domestic Product (GDP) is one of the few economic concepts that almost everyone recognises. It crops up daily in the news and is cited repeatedly by politicians, journalists, employers and bankers.

According to the Bank of England, GDP is a measure of the size and health of a country's economy over a period of time – usually one quarter or one year. It is also used to compare the size of different economies at a different point in time. GDP figures are calculated using one of three measures: the total value of goods and services produced; everyone's income; or what everyone in the country has spent.

Part of its appeal is that it captures all economic production by individuals, companies and the government in a single

measure, which should rise in good times and fall in bad. It is seen as a gauge of a government's performance and is a key component for setting interest rates and tax and spending policy.

It was originally designed by Nobel Laureate US economist Simon Kuznets in 1937 in response to demands by the government following the Great Depression. In 1944, it became the standard tool for measuring a country's economy by bodies such as the International Monetary Fund (IMF).

But by 1958, its shortcomings had become apparent, with the American politician Robert F Kennedy lambasting the perverse outcomes he saw flowing from the way it was defined. "It counts air pollution and cigarette advertising, and ambulances to clear our highways

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“Counting widgets or app downloads hardly cuts it as a measure of social progress”

MATTHEW TAYLOR

>> of carnage,” he said. “Yet it measures neither our wit nor our courage, neither our wisdom nor our learning, neither our compassion nor our devotion to our country; it measures everything in short, except that which makes life worthwhile.”

Half a century on and a growing number of economists believe GDP’s shortcomings go beyond that: in today’s post-industrial age, most economic activity takes place in the services sectors rather than in factories where output can easily be counted.

Matthew Taylor, chief executive of the Royal Society for the Encouragement of Arts, Manufactures and Commerce (RSA), says it fails to capture the quality and experience of consumption that are increasingly key to understanding post-industrial societies.

**Welfare measure**

Despite warnings from Kuznets himself, GDP has been used as a proxy for human welfare and development. “But counting widgets or even app downloads hardly cuts it as a measure of social progress,” says Matthew.

Diane Coyle, professor of economics at the University of Cambridge and author of *GDP: A brief but affectionate history*, tells *The Review* that the limit of GDP as a measure of economic welfare is that it



“GDP has never captured well the effects of substantial new innovation”

DIANE COYLE

largely records monetary transactions at their market prices.

Calculating GDP involves assessing the value of the goods and services produced (nominal GDP) before adjusting it to take account of prices (real GDP). For example, if the value of shoe output rises

by 5% but the price of shoes increases by 5%, then there is zero gain in real GDP.

This has left GDP ill-equipped to capture the impact of technological innovation that has seen the quality of services improve as their prices have fallen. “GDP has never captured well the effects of substantial new innovation,” says Diane.

She says people are increasingly self-employed through digital platforms. Their hours may be flexible, and work can overlap with other activities. In many cases they use household assets, from computers and smartphones to their homes and cars, for paid work.

“Many people contribute free digital work such as writing open-source software that can substitute for marketed equivalents, and it clearly has great economic value despite a price of zero.”

“It is difficult to measure the service sector as well as capturing nominal versus real GDP”

LORD (JIM) O’NEILL



Lord (Jim) O’Neill, a former UK Treasury minister and chief economist at Goldman Sachs Asset Management, agrees, saying: “It is difficult to measure the service sector as well as capturing nominal versus real GDP with many prices shifting sharply in technology-influenced areas.”

An associated problem is its inability to capture the value of household work because of a convention that although households do productive things, they are not part of GDP. “Feminist economists have said for a long time that household productivity ought to be included. And whether or not you think it should, it is also the case that there is substitution: you can either do your washing yourself or take it to the cleaners,” Diane says.

**Environmental accounting**

When, 50 years ago, Kennedy spoke about GDP counting air pollution, he was referring to the problem, which remains true today, that GDP counts many things that destroy the environment, health and world peace as positive contributors to the health of a nation’s economy. What it fails to do is account for the negative costs of these things.



**GDP fails to capture the ‘balance sheet’ of human, financial and physical capital”**

DAVID PILLING



GDP neither accounts for pollution and other environmental impacts nor incorporates changes in the value of assets, such as the depletion of resources or loss of biodiversity. “Neither the unsustainable consumption of the Earth’s resources nor the pollution and degrading of its life-sustaining ecosystems are counted as costs for GDP,” says the RSA’s Matthew.

This leads into the wider concern that GDP does not capture changes in economic welfare – even though many commentators use GDP as shorthand for those wider measures of well-being.

David Pilling, author of *The Growth Delusion* and Africa editor of the *Financial Times*, tells *The Review* that GDP fails to capture the “balance sheet” of human, financial and physical capital. As an aggregate number it conceals differences between different groups within a country that may be experiencing very different levels of economic activity. Matthew agrees, adding: “Unequal societies can appear more successful than more equal ones if measures are only in GDP per head, even though most people might not be benefiting.”

Aiming to maximise GDP can lead to perverse outcomes, such as introducing a seven-day working week, lowering environmental standards or selling off unproductive green spaces. “If higher GDP means more money to spend on the things we want, that’s great,” David says. “But higher GDP ought not to be the goal.”

**Alternative measures**

These concerns have prompted the creation of alternative measures. In 1972, Yale economists William Nordhaus and James Tobin introduced their Measure of Economic Welfare that includes the value of leisure time and the amount of unpaid work and subtracts a measure of environmental damage. The Index of Sustainable Economic Welfare (ISEW) built on

this in 1989 by considering a wider range of harmful effects of economic growth, and by excluding the value of public expenditure on defence.

The RSA’s Inclusive Growth Commission proposed publishing a Quality Gross Value Added alongside GDP, including indicators as diverse as life expectancy and health inequalities, school readiness of children at five years, and quality of private rented housing. But Matthew doubts GDP will be dethroned anytime soon because of the linkage between economic output, tax and public services. “To really wean ourselves off GDP, we need a deeper economic transformation,” he says.

Lord O’Neill is dubious about replacing GDP with an alternative, saying it is more important to improve how GDP is calculated. Ruth Lea, economic adviser to Arbutnot Banking Group, agrees, saying that GDP remains a key measure but should not be treated in isolation when determining policies, which should also include income distribution, if appropriate to the policies in question.



**Statisticians agonise over ways to capture phenomena that were not relevant years ago”**

GIAN MARIA MILESI-FERRETTI



Gian Maria Milesi-Ferretti, deputy director in the International Monetary Fund’s research department, doubts GDP will disappear as the fund’s main indicator in its biannual world economic outlook. “I can see reasons why you would make the measure more attuned to the changes in the way production takes place. It is not a static measure and statisticians agonise over ways to capture phenomena that were not relevant years ago. Sometimes GDP is given short shrift in a very superficial way as something left untouched since the 1930s.”

Even critics of the way that GDP is used by policymakers, such as David, do not believe its days are numbered. “GDP is a brilliant invention: all human activity compressed into a single number. It is useful – it is just not enough.” ●



**FURTHER READING**

To access the links, point your smartphone or PC camera at the QR code, or do the same with a QR code scanning app, downloaded onto your smartphone from the App Store.



***The Growth Delusion*, by David Pilling, published by Bloomsbury Publishing**



***GDP: A brief but affectionate history*, by Diane Coyle, published by Princeton University Press**



***Making our economy work for everyone, the final report of the RSA’s Inclusive Growth Commission***



# An opportunity to help

MICHAEL COLE-FONTAYN MCSI, THE CISI'S NEW CHAIRMAN, HAS ENJOYED A SUCCESSFUL 35-YEAR CAREER IN BANKING. NOW, HE WANTS TO USE HIS CHAIRMANSHIP TO OFFER THE WIDER SECTOR THE BENEFIT OF HIS EXPERIENCE. **EILA MADDEN** REPORTS

A few years ago, Michael Cole-Fontayn wrote a letter to his 17-year-old self. He had two related pieces of wisdom to share.

The first was to be relentlessly curious. The second was to commit to lifelong learning as early as possible. As the new chairman of the CISI – an institute with lifelong learning at its core – he has certainly come to the right place.

However, Michael almost missed crossing paths with the CISI entirely. Financial services was only intended to be a stopgap for a young Michael, who graduated from the University of Westminster in 1983 with a BA in Business Management.

“Needless to say, it didn’t work that way and I found the world of banking and finance very stimulating,” says Michael, who joined the Bank of New York (BNY) upon graduation. “It allowed me to train in New York on the graduate training programme and to work in London during

one of the most momentous changes in financial services – the Big Bang. I saw rapid development in financial services and the impact it had on the City of London.”

### A witness to history

His time at BNY gave him a ringside seat at many more of the biggest financial events in history. He was part of the first hostile takeover of another bank when BNY acquired Irving Trust.

In the early 1990s, Michael, then in his early 30s, was sent on assignment to Hong Kong. He saw, at first hand, China’s embrace of a market-based economy with Chinese characteristics, the rapid development of the Indian economy and the subsequent rise of the Asian economy as a whole. He was also there when the UK returned Hong Kong to China.

On leaving Asia, Michael came to work for BNY’s London operation, running the group’s equity solutions and depository receipts business globally. Although based in London, his work took him all over the

// THIS PROFESSION IS SOMETHING THAT I HAVE SPENT MY LIFE PURSUING, ENSURING THAT SECURITIES AND INVESTMENT IS UNDERSTOOD //

world during that period, enabling him to witness the global consequences of the 2008 financial crisis. “There were a lot of lessons learnt for all aspects of the market during that period, when the financial services sector generally lost the trust of society,” he says.

In 2011, he was appointed chairman of Europe, the Middle East and Africa for what had become BNY Mellon – a role he held until 2017. Retiring from the bank after a successful 35 years, he has graduated to a portfolio career.

As part of that, he is currently chairman of the Association for Financial Markets in Europe (AFME), which is focused on delivering an optimal Brexit for wholesale financial services and helping to deliver the risk reduction package that regulators have been implementing since the financial crisis. The association has also been asking members to implement, and ensure that there is a positive outcome to, banking union and capital markets union implementation within Europe. This will provide more stability in EU markets and more sources of finance across Europe in years to come.

### Coming to the CISI

Through his work at BNY Mellon, helping companies to list on the London Stock Exchange (LSE), Michael has always been aware of the CISI’s roots as the education arm of the LSE and of its work to build professionalism within the sector through its qualifications and focus on ethical behaviour. He has been impressed with the institute’s emphasis on this role in the aftermath of the financial crisis.

“This profession is something that I have spent my life pursuing, ensuring that securities and investment is understood. When I was approached to be considered

for the role of chairman of the CISI, it immediately appealed. This is an opportunity to apply my 35 years’ experience in financial services around the world to support the achievement of the CISI’s goal of promoting the highest level of professional competence and integrity to members, individuals and firms.”

He brings a deep commitment to the end investor and dedication to ensuring the CISI remains focused on delivering the standards of professionalism and conduct that savers have every right to expect from financial intermediaries. In ever more complex, ambiguous and volatile times, he wants savers to be able to rely on trusted advice and financial planning.

### The CISI abroad

Michael believes CISI qualifications and continuing professional development (CPD) should be the bedrock for any aspiring financial services executive to ensure that they have the most up-to-date information about standards, conduct and professional behaviour and a robust understanding of the evolving requirements to practise the profession.

He welcomes the fact that practitioners in other parts of the world now have the opportunity to build this career foundation, thanks to the success of the CISI’s overseas expansion, and he is pleased to see how well-regarded the institute is in its new markets in Africa, the Middle East and Asia. Future expansion, he says, should be smart and focused, with the CISI partnering with regulators, global firms and governments to spread the highly-regarded standards of the UK market farther afield.

There are also opportunities for growth in Europe. As European supervisory agencies, such as the European Securities and Markets Authority, define the standards of professional behaviour that they expect to see in financial markets via the Markets in Financial Instruments Directive II (MiFID II) rules, Michael believes there will be greater demand for the style of professional qualifications and CPD that the CISI delivers.

He finds the institute in good health, with “an excellent management team, a committed Board of Directors and a wonderful army of volunteers. I would be looking to oversee how we’re executing our plan for the

## Michael Cole-Fontayn MCSI

### On diversity

“I’ve seen time and time again that a range of diverse views and opinions leads to better business outcomes, so I am completely sold on the business case.”

### On mental health

“Within our organisations, we have a duty of care for the well-being of all of our employees in a way that helps maximise their potential, whether to serve clients, to control risk in the environment, or to ensure optimal team performance and, ultimately, that has an impact on productivity in the sector and in this country.”

### On career development

“As early as possible in life, commit to lifelong learning and be relentlessly curious. Try to have a new insight or learn a new fact every day. Our sector is about helping to improve lives through saving and investing. Part of the expectation that our clients will have is that we continue to invest in our own knowledge and professional development.”

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## CV

**Oct 2018:** Takes on the chairmanship of the CISI

**Jan 2018:** Appointed chairman of the Association for Financial Markets in Europe

**2017:** Retires from BNY Mellon after a 35-year career at the firm

**2011:** Promoted to chairman of EMEA at BNY Mellon

**1983:** Joins Bank of New York as credit and risk analyst

**1983:** Graduates from the University of Westminster with a BA in Business Management

>> next several years to ensure that we continue to fulfil our educational mandate in the broadest sense and that we remain fit for purpose in very dynamic markets where there is considerable structural change taking place as a result of regulation, technology and the geopolitical environment. All of those affect knowledge, behaviour, professionalism and conduct in our markets.”

Ensuring the CISI flourishes and is fit for purpose includes growing membership by continuing to make the achievement of CISI qualifications a point of pride. Promoting ethical behaviour includes the continuous rolling out of the CISI IntegrityMatters programme.

**The financial crisis**

Taking pride in the profession is an important part of the recovery process for the sector as a whole as it reflects on lessons learnt in the ten years since the financial crisis. Michael believes isolated pockets of behaviour evolved into market convention because some parts of the wholesale markets did not have sufficient regulatory scrutiny.

The impact on savers has, he says, been exceptionally high and this has informed the political and regulatory response. He believes the sector must now hold itself accountable for its actions, which should be focused on ensuring a fair outcome for those who rely on the sector for their savings, investment and planning. “It is almost a rediscovery of what it means to be professional, which the institute is dedicated to ensuring and enabling,” he says.

Integrity in financial services is critical and the sector is still learning lessons, particularly in the ‘grey areas’ where regulation needs to be translated, understood, implemented and embedded in the processes and behaviours of regulated institutions.

Michael says the Senior Managers and Certification Regime has helped to clear up some of those grey areas, such as clarifying the definitions of terms, including ‘responsibility’, ‘accountability’ and ‘authority’. The Banking Standards Board and the Fixed Income, Currencies and Commodities Markets Standards Board have also been doing some very good work on patterns and causes of misconduct, and standards of behaviour, he adds, but to help people comply, the sector needs to be based on, supported and evidenced by relevant and rigorous qualifications.

// TAKING PRIDE IN THE PROFESSION IS AN IMPORTANT PART OF THE RECOVERY //

sector must take responsibility to stress test its own facts and evidence, backing them up with credible examples. He hopes this will help to convince Brexit negotiators that the sector is not crying wolf with its concerns and that it is doing all that it can to manage the risks in a way that is clear, professional and appropriate.



“ There were lessons learnt for all aspects of the market during the crisis, when the sector lost the trust of society ”

As chairman of AFME, Michael sits on the European Financial Services Chairmen’s Advisory Committee (EFSCAC). Set up after the UK’s vote to leave the EU, EFSCAC helps to coordinate sector responses to Brexit preparations and to facilitate dialogue between government and financial services representatives.

So far, the committee’s focus has been on educating politicians and policymakers about the interconnectedness of the European financial system, particularly when it comes to issues such as supply and distribution chains and the continuity of insurance and derivatives contracts. “We want to ensure that these hygiene factors are understood because the last thing that anybody in the sector wants to see is another period of instability that is borne out of misjudgement or a lack of true understanding,” says Michael.

Being fact- and evidence-based will help to win the trust of all politicians and policymakers. At a time when experts are losing their authority, Michael believes the

He believes the Bank of England’s plans for a ‘temporary permissions regime’ is a sign that the sector is being heard. The plans allow EU-based firms regulated in the UK by the FCA and the Prudential Regulation Authority to continue operating within the scope of their permissions after Brexit for an, as yet, undefined period.

**Continuity through volatility**

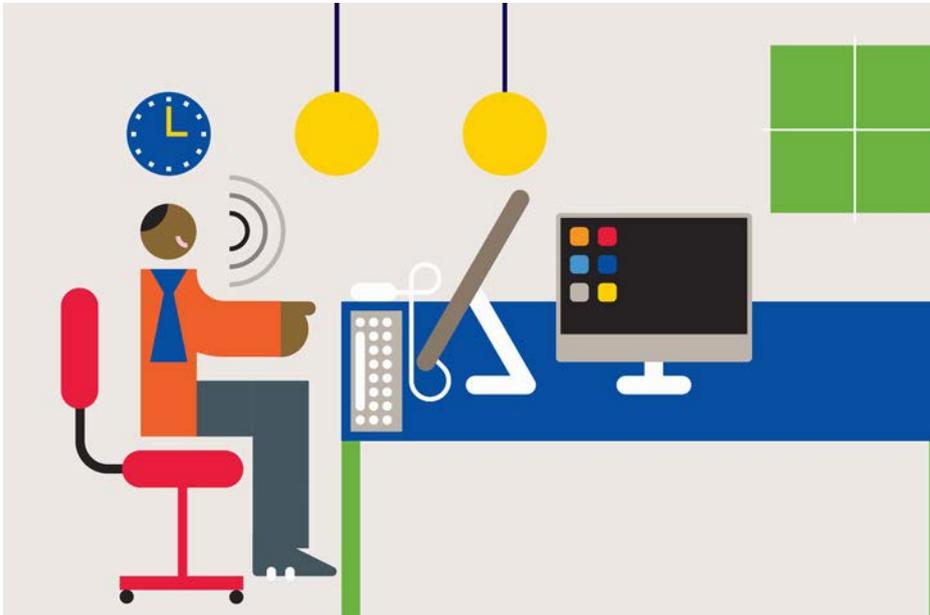
Despite such occasional glimmers of good news, with Brexit headlines changing on a daily basis, does Michael fear that the UK will leave the EU with no deal? If it does, he believes a critical mass of financial services firms will be ready to serve clients with continuity through any volatility. However, he says it is in the world’s interest for the UK and EU to negotiate an appropriate deal. Without one, any subsequent financial or economic instability in the UK might have effects across the global financial system.

“What we need is political trust and confidence to build in a way that will fulfil the British side of the Brexit mandate and fulfil the expectations of 450 million European citizens that this is not a financially disruptive event,” Michael says.

His efforts to win the best outcome for the financial services sector will no doubt ramp up as we draw nearer to the leave date of March 2019. It seems that Michael has never stopped being witness to the historical events that shape the sector – an insight that CISI members will benefit from as they get to know their new chairman. ●

RECRUITING A BUSINESS MANAGER CAN REVOLUTIONISE A SMALL FIRM'S FORTUNES BY HAVING SOMEONE TO TAKE ON THE ADMINISTRATION BURDEN, IMPLEMENT EFFICIENCIES AND FREE BUSINESS OWNERS UP TO ADVISE CLIENTS. **SANDRA PAUL** REPORTS

# Business manager wanted



The financial planning profession has changed significantly over the past ten years. The era of one-person firms is becoming less common as increasing regulation and client demands present a greater challenge for smaller firms.

Today, one of the greatest irritants sole practitioners have is the small amount of time they can spend with clients. Most of the working week is spent keeping the plates spinning as they switch from tasks such as answering the office phones to applying for professional indemnity insurance.

However, firms that are seeking to grow are realising that to deliver a truly professional level of service to clients, it's almost impossible to do everything alone.

## Bringing in support

One option is to bring in a business manager to run the business for you, freeing you up to focus on client-facing work. However,

the obvious questions arise: Where do you find a business manager? How can you ensure you recruit the right person? Fitting into a small, 'unique' firm may not be that easy. What if they completely change your processes, confusing you and your clients? It can be a costly mistake.

There are practical ways to reduce the risk of hiring the wrong person. This is particularly crucial for a small firm in which the business manager may only be the third or fourth hire in the business's history.

"In that instance, you're talking about hiring a third or quarter of your business," says Mark Horstman, CEO of management consulting firm Manager Tools. "Imagine a big company with 1,000 people suddenly hiring 250 more and them all being bad. You'd crush the business. That's the problem with hiring the wrong person, if it's the fourth person on your team."

To avoid this, Mark says business owners should start building their

// FIRMS THAT ARE SEEKING TO GROW ARE REALISING THAT IT'S ALMOST IMPOSSIBLE TO DO EVERYTHING ALONE //

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>> recruitment pipeline, or ‘bench’, from day one. This means constantly looking for people who you click with in terms of values, professionally and personally. Attending two to three conferences a year is a good way to meet people to fill your recruitment pipeline.

“When you do finally identify that you’re ready to hire, you want a lot of people to pick from,” says Mark. “You certainly don’t want to just advertise and let your decision about whether or not you’re going to spend the next 10 or 15 years of your life sitting right next to someone boil down to an hour or two-hour face-to-face interview.”

Once you’ve built a bench of potential recruits, build a high wall around your firm for them to get over, Mark advises. This hurdle protects the firm and its existing employees from the wrong hire. That wall is built from a rigorous three-step process that involves assessing a candidate’s CV, putting them through a half-hour phone screening and then bringing them in for a full or half day of interviews (see panel, opposite).

“The purpose of an interview is to find reasons to say no to someone,” Mark says. “If there is anything that bothers you about a person, don’t hire them. The only thing worse than having an open position in your firm, even if your firm is struggling with growth, is hiring the wrong person because if they don’t do what you want them to do, you’ll still be struggling for growth but now you’ll have less time because you’re busy managing the conflicts and the difficulties that the wrong person brings with them.”

**But first**

Before starting to recruit, business owners should do some ground work, advises Phil Young, a consultant who coaches business owners and senior managers.

First, make sure you’ve agreed the scope of the role and written it down. Phil often sees business owners looking for an ‘operations person’, which can very loosely mean ‘all the things I don’t want to do’, but without defining what it will involve. If you’re not clear on this, your new hire may think they have a broad remit and you’ll then be in the awkward position of having to disempower them by telling them certain things are off limits.

Second, operational and finance roles in a small business will often need to cover several areas, so it’s important to decide where your weaknesses are and which aspects you want to retain.

However, even before thinking about how to recruit a business manager, business



“If there is anything that bothers you about a person, don’t hire them”

MARK HORSTMAN, CEO OF MANAGER TOOLS

PHOTO: MANAGER TOOLS

owners will need to identify whether this is the right option for them. Many firms will use the talents of a business consultant to help them identify next steps for growth. Consultants will cover client segmentation, analysis of fees and charges, marketing and branding exercises and a fresh look at the business goals and plan. Alongside a business plan, they will help you to articulate your vision by asking the following questions: What is your value proposition? How does the service model and process work? Is it consistent and sustainable? Having a clear vision of what you want your business to look like is vital, and creating a business plan will help to cement the vision in your head, and eventually, in the heads of the staff you recruit.

Dominique Sieradzka is founder of RIE Solutions, a business consultancy helping firms become more efficient and profitable.

To help uncover the right solution, she begins by identifying the strengths, weaknesses, likes and dislikes of the key individuals in the business. Often, the main business owner is also the face of the practice or business and it is likely that their strengths are client-facing and their weaknesses, the ‘boring paperwork stuff’.

Next, she works out their capacity throughout the year using her trademarked ‘Capacity Calculator’. Once you take away weekends, holidays, training days and team meetings, you start to realise how little time during the year you have for all of the different key responsibilities that are within your remit. Often, this is quite an eye-opener when the owner realises how little time they

// THE PURPOSE OF AN INTERVIEW IS TO FIND REASONS TO SAY NO TO SOMEONE //

have for face-to-face financial planning with clients. The third exercise is to list the tasks of the business, which, for an average financial planning firm, is over 100.

“If your objective is to grow, you need to go out and find someone who is going to complement the skills and experience that you have,” says Dominique.

### Justifying the cost

By appointing a specific individual to handle the running of the business, not only are any areas of potential difficulty regarding the division of responsibilities avoided, but business owners are able to concentrate on their actual job of financial planning for clients, as well as being free from any conflict of interest that trying to carry out both of these roles could create. However, many small businesses question how they can justify the added costs to their business of an additional person.

Phil says: “Many financial planners, like their clients, value peace of mind over anything else, and while some firms recognise that they need to bring in managers to grow, others want to get some of their life back after establishing the business and are happy just to hand over things like line management, HR, finance, regulation and all the other stuff they never dreamt of doing when they set up a business. I always warn that hiring a manager is a pure cost so be honest about what the return will be. It isn't always financial.”

Indeed, understanding that the ‘other bits’ of the business are crucial is a light-bulb moment. Creating an excellent client experience from start to finish, with well-managed structures and processes underpinning everything, will increase profitability. After all, if your eventual goal is to sell your business, no investor will look at you unless you have these basics in place.

### The outsourcing option

Some of these roles and ‘jobs’ can be outsourced. Outsourcing specialist areas such as HR, IT, administrative, legal, compliance and paraplanning may free you up to concentrate on increasing client numbers and improving service.

For example, you may be keen on using digital technology to provide your clients with a 24/7 view of their net worth, income and expenditure, financial documents and financial planning strategy. Fully engaging with technology may increase your business efficiency and help you deliver tools with multigenerational appeal. This will ultimately have a positive impact on

your profitability, but you must choose an outsourced IT company that will interact seamlessly with your database, processes, contact history and client documentation (see our online article about integrating technology into financial planning, [cisi.org/itfp](http://cisi.org/itfp)).

### Casting a wide net

For those who decide to go down the recruitment route, recruiting the right person doesn't mean you have to restrict your search to the financial planning or wealth management professions.

Jason Betteridge, managing director of Edinburgh-based financial planning firm Sutherland Independent, had already decided to hire someone for his business to drive growth and embed his vision, when, during a business dinner, someone recommended an ex-banker to him. Five years later, Jason says she is integral to his firm's business performance. From working initially five days per week, she is now employed to keep things on course just two days per week. The decrease in the time spent on the business doesn't mean a decrease in business efficiency or improvements. The firm has followed her strategies for growth and she can reduce the time she spends on implementation.

### Recruitment sources

Recruitment can be through a variety of sources. Beyond building a recruitment pipeline through networking, as Mark advises, the more traditional routes include advertising, recruitment consultants, headhunters and LinkedIn. Typically, from identifying the need to recruit to having a person in place can take nine months, according to Dominique, and geographical location can have a huge impact. In London or the major cities, it may be easier to recruit an individual with the requisite skills, qualifications and experience. The talent pool decreases outside these regions. In cases like these, small businesses have done extremely well using the talents of a practice manager on a project basis to whip the business into shape.

Remuneration is a barrier for some. The role is a senior one and must be remunerated accordingly. This person is going to ensure that they bring your vision to life while you see clients. You want the right candidate in the seat because you need to know that not only will they drive the business forward, but that they will do it better than you. ●

## MARK HORSTMAN'S THREE-STEP INTERVIEW PROCESS:

Mark Horstman, CEO of Manager Tools, describes the interview process as one of constructing a wall around your business which is designed to allow only the best to get over.

### Step 1: The CV

Review a candidate's CV to compare what they have done in the past with what you'll be asking them to do in the future.

### Step 2: The phone screening

Put the candidate through a half-hour phone screening. Look for all the things that you would expect of a professional colleague: punctuality; their undivided attention; a pleasant and polite demeanour; and a cheerful voice.

### Step 3: The interview

Hold face-to-face interviews with the candidate for at least half a day to explore their suitability for the job. Encourage your employees to interview them too. This longer process will allow you to make an analytical decision rather than one made on gut instinct.

To ensure every candidate has an equal chance, have your interview questions in front of you and ask everyone the same questions. This will also ensure that you focus on listening to the candidate's answers rather than thinking about the next question you're going to ask.

Use behavioural interviewing techniques, which are based on the assumption that the best predictor of future performance is past performance. Construct questions that draw examples from the candidate of behaviours that you see as critical to the job you're hiring for.

Every single step in this process is a hurdle for the candidate to get over, says Mark. “If you interview four people and end up saying yes to all four of them, you haven't built your wall high enough.”



# Considering REITs

REAL ESTATE INVESTMENT TRUSTS GIVE ORDINARY INVESTORS EXPOSURE TO THE PHYSICAL COMMERCIAL PROPERTY MARKET. THEIR TENDENCY TO TRADE AT A DISCOUNT TO NET ASSET VALUE MAKES THEM PARTICULARLY ATTRACTIVE. **PHIL THORNTON** OFFERS A STARTER'S GUIDE TO HOW THEY WORK AND WHY THEY COULD BE A GOOD INVESTMENT.

Originally developed in the US in the 1960s, Real Estate Investment Trusts (REITs) were launched in the UK in 2007 and have become a popular way for ordinary investors to gain access to the physical commercial property market. More than 80% of British property companies, which either own land or trade in land, have so far converted to REITs.

The British Property Federation (BPF), the membership organisation for the UK real estate industry, played a key role in the creation of the companies. "We were one of the key bodies that persuaded the government to introduce legislation allowing property companies to convert to REITs," says Melanie Leech, the BPF's chief executive.

Conversion carries substantial tax benefits. REITs do not pay corporation or capital gains tax on their property investments. They are essentially companies that manage a portfolio of real estate to earn profits for investors. Their special tax status means that they also pay no corporation tax on the profits of their rental business.

Aisling Colgan, a director in Deloitte's real estate tax group, says that REITs seek to apply tax "as if the investor holds the bricks and mortar themselves". This means many classes of investors enjoy enhanced investor returns when they invest in a REIT versus a typical corporate structure – this particularly includes pension funds, investors who use tax-free individual savings accounts (ISAs), and sovereign wealth funds.

For example, a traditional UK property firm earning income of, say, £100,000 would pay 19% or £19,000 in tax, leaving £81,000 for investors, who would be liable for tax on that dividend according to their tax status. The higher rate is 32.5%, so leaving them with £54,675. A REIT is exempt from the tax on the income and so can distribute the full £100,000. Investors pay tax on that as an income at 20%, 40% or 45%, depending on their status. An investor liable for 40% tax would keep £60,000. However, the biggest beneficiaries from REITs are ISAs and pensions funds, where rental income is not taxed.

In exchange for these tax advantages, REITs must obey strict rules. To qualify:

// MORE THAN 80% OF BRITISH PROPERTY COMPANIES HAVE SO FAR CONVERTED TO REITS //

- ▶ at least 75% of profits must come from property rental
- ▶ they must pay out 90% of their rental income to shareholders
- ▶ they must be primarily engaged in property investment, rather than in development or other non-property related activities.

### How REITs work

Unlike other property investments, REITs shares are traded on the London Stock Exchange. “As REITs are all listed property companies, trading shares in REITs is very liquid,” Melanie says. This is because investors can sell shares in REITs, making them a liquid investment – even though the assets in the fund itself are less liquid.

These are the UK rules: some 34 other countries from Australia to Turkey allow REITs, and the rules vary across the world. In the US, REITs are not required to list their shares on a public exchange.

But Deloitte’s Aisling says there are many common features of REITs that make them a globally-recognised brand. “Even though there are slightly different rules in different jurisdictions across the world, they share fundamental principles: they invest in property, are widely-held, and distribute regularly.” They also have the advantage of paying a dividend, which means investors receive an income on their investment.

One feature of REITs is that their shares often trade at a discount to their net asset value (NAV). There are several reasons for this. First, the share price may suffer from general falls in the market that will pull the price below the value of the assets. Second, investors may be sending a signal that they believe the assets are overvalued. Last, investors may believe that while the assets are valuable, the management is unlikely to produce future growth. This offers a potential reward to investors who can buy the shares at a discount and sell at a premium when the share price rises above the NAV, so narrowing the discount between the price and the NAV (see box, right).

Many academic studies have looked at why shares in REITs and other property-based funds are sometimes priced below their NAV – referred to as the closed-end puzzle. One of the most-cited explanations is simply that the NAV has been miscalculated because the assets are illiquid and therefore hard to value. A connected reason is similar but is based on the fear that the NAV does not account for future tax liabilities. Another is that investors are worried that poor

performance in the management of the fund or an overcharge of management fees will give them lower returns (even if the value of the assets is correct).

### Closed- vs open-ended funds

The NAV is an important metric because a REIT can be a ‘closed-ended’ or an ‘open-ended’ fund. Both pool the resources of many investors to be able to invest on a larger and wider scale, but operate in very different ways.

Shares of open-ended funds, such as mutual funds, are bought and sold directly from the fund manager. The number of shares is not fixed, and the fund creates and cancels as many shares as investors wish to buy or sell. However, fund managers have to keep funds in cash to meet demands from investors suddenly wishing to sell.

Laith Khalaf, senior analyst at investment management firm Hargreaves Lansdown, says open-ended funds keep 10% or more in cash in case investors demand the immediate return of their money. Open-ended funds may also take advantage of purchase opportunities or because an investment has recently been sold (see box, page 40).

For open-ended mutual funds, NAV is a useful factor for tracing share price movements. However, it is not useful for assessing overall fund performance, which is measured by the share price.

A closed-ended fund has a fixed number of shares in issue, offered by an investment company. It typically has a lock-in period and share value is determined in the secondary markets, which are formal exchanges, where the shares are traded.

The NAV of a closed-ended fund is the price per share multiplied by the total number of shares. The value of such funds changes continuously throughout the trading day and trading cycle.

Another difference from an investor’s perspective is that open-ended funds can suspend trading if the market turns particularly negative. As well as preventing other investors encashing their funds, it means bargain-seeking investors cannot acquire assets cheaply. This is especially the case for illiquid assets such as property.

### Pros and cons of investing in REITs

When looking at REITs, investors need to realise that although they are buying a share, they are gaining exposure to the property markets. This comes with pros and cons, according to Laith.

### How discounts to NAV work

The net asset value (NAV) is one of the most important concepts investors in close-ended funds need to understand. Knowing how to use the NAV to determine a fund’s fair value will give an investor a tool to help identify funds with the potential to outperform.

NAV measures the value of a fund’s assets, minus its liabilities. The formula is the market value of all securities held by a fund, plus any cash and equivalent holdings, minus any fund liabilities. Dividing that figure by the total fund shares gives a per share figure. If the NAV is, say, £10 but the share price is £9 then an investor is buying an extra £1 of assets and will receive income on £10 worth of assets.

However, an investor can only sell the share at the prevailing share price, so if buying a REIT at £9, they will have to wait to see if the price catches up with the NAV. In the meantime, they will focus on the daily price and dividend payments.

All markets are likely to rise in value over the years, so there should be a natural increase in the share price. Even if the discount were to remain at 10%, in time we would expect the share price to rise as the value of the underlying assets rise. If an investor sold at 10% discount, it would be 10% of the new (higher) NAV and that monetary amount is likely to be higher than the £9 they paid at the outset.

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// THE KEY IS TO INVEST IN A PLANNED MANNER AS PART OF A WIDER STRATEGY THAT TAKES INTO ACCOUNT ALL ASSETS //

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“There are a couple of reasons why you want that exposure,” he says. “Property can deliver a reasonable income stream for investors. Then there is diversification – more traditional investments include equities, bonds and cash and this is a good way to have a fourth string to your bow in the form of property.”

As a REIT is a property investment company, it can be easily traded on the stock exchange. However, the way your investment is calculated depends on whether it is open- or closed-ended, which is something stock market investors in REITs need to consider. In an open-ended REIT, share values are calculated once per day after the stock market is closed. Share prices for a closed-ended REIT are based on what investors are willing to pay for them at any given time.

One particular issue is the difficulty in valuing the underlying assets. The valuation of real estate assets held by REITs is undertaken on a periodic basis by the Royal Institution of Chartered Surveyors (RICS) Registered Valuers. Philip Parnell, a partner at Deloitte, says that although frequency is at variance to the ‘real time’ movement of equity prices, it is generally regarded as more practicable and realistic given the less liquid nature of physical real estate as an asset class and the relatively fewer observable comparable transactions

upon which valuers can form their opinions. “Nonetheless, the time between valuations can inevitably lead to notable adjustments – up or down – upon each valuation, particularly in the aftermath of major market events such as the EU Referendum and the 2008 financial crisis,” he says. “The premium or discount to NAV can provide an important indicator as to investor perception regarding the potential direction of value of the underlying real estate ahead of the next valuation.”

A REIT must include in its annual financial report formal valuation of its portfolio by an external valuer. There is no universal method or basis of valuing assets and liabilities for the purposes of calculating the net asset value used throughout the world.

The widely accepted International Accounting Standard 40 (IAS40) for investment property applies to the accounting for property (land and/or buildings) held to earn rentals or for capital appreciation (or both). It allows valuers to choose between a fair value model and a cost model.

According to IASplus, a central news repository curated by Deloitte, fair value is the amount for which the property could be exchanged between knowledgeable, willing parties in an arm’s length transaction. The best evidence is normally given by current prices on an active market for similar property in the same location and condition and subject to similar lease and other contracts. In the absence of such information, the valuer may consider current prices for properties of a different nature or subject to different conditions, recent prices on less active markets with adjustments to reflect changes in economic conditions, and discounted cash flow projections based on reliable estimates of future cash flows. Under the cost model, investment property is accounted for in accordance with the cost model as set out in IAS 16 Property, Plant and Equipment – cost less accumulated depreciation and less accumulated impairment losses.

#### Investment risks

When to invest in REITs is hard to know as there are always risks going into the property market. The key is to invest in a planned manner as part of a wider strategy that considers all assets. An investor’s objectives, time horizons, attitude to risk and capacity for loss should also be considered before any investment decisions are made. ●

#### WHY DO REITs HOLD CASH?

Although REITs are commercial property funds, they are allowed to hold cash, which may be unappealing to investors who are paying management fees and who could invest cash themselves.

Deloitte’s Aisling Colgan says the cash allowance stems from a problem with the original REITs legislation in the 2006 Finance Act that did not consider cash as a ‘good asset’ for the purposes of meeting the conditions to qualify as a REIT. It particularly caused issues on launch when the cash balances were disproportionately higher than the property assets held.

This was resolved with reforms in the 2012 Finance Act in the UK that allowed cash to be included as a good asset for REIT condition purposes as well as abolishing a 2% charge on assets that companies introduced

into a REIT. “The REIT legislation recognises that holding cash on launch or following a capital raise should not impede a group’s ability to qualify as a REIT. It’s not as if property companies will sit on shedloads of cash; it will be invested in property to generate returns for investors,” Aisling says.

So, while REITs can hold cash as part of a sensible investment strategy, they are likely to do this to take advantage of purchase opportunities or because an investment has recently been sold, rather than for investor redemptions. REITs are likely to keep 1%–2% in cash for those reasons, says Laith Khalaf, of Hargreaves Lansdown.

Unlike other property investments, REITs shares are traded on the London Stock Exchange, allowing investors to exit their investment by selling shares.

“  
**The knowledge  
that retirement  
is possible is the  
most important  
thing to clients**”

*Phil Billingham CFP™  
Chartered MCSI, p.43*



**pp.42-48**  
*Tips, tricks and  
know-how to  
make you a better  
financial services  
professional*

**pp.44-45**  
*A financial  
planning firm  
inadvertently  
accesses clients'  
photos, contacts  
and location  
services. How  
should it handle  
this data breach?*

“  
**Firms should not be surprised  
if the regulator now takes  
an interest in how senior  
management responds to and  
investigates allegations of  
sexual misconduct and poor  
personal misconduct**”

*Richard Burger, Chartered FCSI,  
partner, DWF LLP, p.47*



# World citizens – a practical example

**PHIL BILLINGHAM** CFP™ CHARTERED MCSI, DIRECTOR AT PERCEPTIVE PLANNING, UNRAVELS A COUPLE'S FIENDISHLY COMPLEX FINANCIAL SITUATION RESULTING FROM WORKING IN THREE COUNTRIES, THREE CURRENCIES AND DIFFERENT TAX REGIMES

## THE BRIEF

**Mike and Sally – not their real names – both aged late-50s, had spent their working lives (Mike as a scientist and Sally as a senior civil servant) in Canada, the US and the UK. They had both been born in Canada, but their movement around the globe resulted in them falling in love with a pretty bit of northern England.**

But this was the second place they had fallen in love with. Vancouver had caught their eye several years ago and they had committed to it to the extent that they had bought a home there, and were working with a local financial planner to plan their retirement.

Their financial planner, who we had met at a conference I was speaking at, introduced us to the couple, explaining that she knew she could not help because their financial 'centre of gravity' had moved to the UK, and she was neither competent nor regulated to give advice on the UK position, but that we may be able to.

The change of plan required some working through. The house in Canada needed to be sold, and a new financial plan calculated. This entailed working with assets in three countries, in three currencies, with very different tax regimes.

While any financial planner looking after the couple would have had the same cross-border issues to deal with, UK-based financial planners encounter these frequently, so are experienced in dealing with them. And the couple planned to make a home, and receive/draw down their pensions, in the UK.

They had accumulated pension rights in two of the countries – the UK and Canada – with different tax rules, and different attitudes to interjurisdictional transfers and early encashment.



At our initial meeting, Mike and Sally were well organised and pretty clear in their objectives, which were to buy a house, retire and have enough money to continue their current lifestyle, minus the costs of working.

The main variables were:

- ▶ the price of the house
- ▶ their income, and the difference between discretionary and 'fixed' income
- ▶ longevity
- ▶ morbidity
- ▶ expectations of and experience of inflation – here and in Canada
- ▶ exchange rates.

Clarity of objectives makes it easier to work with clients in many ways, but can throw up obstacles as well.

Mike and Sally were both focused on a very clear outcome, so exploring a range of options (not buying the house, retiring elsewhere, for example) was a process which met with limited success!

The initial stages of the financial plan involved cross-checking of spreadsheets, and then trying to get to the facts behind the numbers.

In short – where was the money coming from? What assumptions had already been made? Did the provider's figures agree with this? How much of this expenditure was 'discretionary' and how much was fixed? How was that going to change?

Having set clear budgets for the house purchase, and a firm figure for the income required, we spent some time calling to and fro across the Atlantic, and in liaison with UK and other tax advisers and financial services providers in different jurisdictions.

We discovered that Canadian pension schemes have no mechanism at all for transferring assets/funds out of Canada to the UK. The people we chatted to were amazed such a thing was even being

ILLUSTRATION: KATIE EDWARDS/IKON



### PHIL BILLINGHAM CFP™ CHARTERED MCSI

Phil joined the profession in 1982. He is a past director of both the Institute of Financial Planning and the Society of Financial Advisers, and a past member of the Financial Planning Standards Board (FPSB) Regulatory Advisory Panel.

He has spoken at conferences and worked with financial planners in the UK, Ireland, Monaco, Portugal, Hungary, the Czech Republic, Bulgaria, France, the US, Canada, South Africa, India and Australia.

Phil is a CFP professional and a Chartered Wealth Manager. He is named as one of the Top 100 Global Influencers 2018 in *International Advisor* magazine.

He specialises in working with clients with assets and lifestyles across different jurisdictions – ‘world citizens’.

contemplated. The only mechanism available was to cash them in. Simple to do, but expensive – you have to pay the tax as if all the income has been received in the year they are cashed.

The biggest surprise was a UK-based pension scheme Mike had acquired (designed for ‘overseas staff’). He had deferred drawing the pension, as he was still working and paying higher rate tax. But this meant the undrawn pension was ‘lost’. There was no credit for the ‘missed’ pension. This was unusual, and we had to keep checking that the pension provider was serious.

It was, so we explained the position to Mike and Sally, who then arranged for the payments to be paid with immediate effect.

We established that they couldn’t achieve all their goals immediately; it had to be one step at a time. They could afford to buy the house they wanted, but not to

// THEY WERE HAPPY TO CARRY ON WORKING, BUT WANTED TO KNOW THE POINT WHERE THEY COULD WALK AWAY WITHOUT TOO MUCH PAIN //

retire straight away. We suggested that they spend some time in the new house, familiarising themselves with the costs involved. We also suggested that they reorganise their affairs to use their available pensions, ISAs and annual capital gains tax allowances and reduce their tax and investment costs. And then save as much as possible, with a view to re-evaluating their situation in three to five years. We would of course keep checking in the meantime.

They were happy to carry on working, but wanted to know the point where they could emotionally and practically walk away without too much pain.

### What happened next

They bought the house for a figure over their initial budget. But they had unexpectedly inherited some money, so we did the projections again, based on the increased assets, and the fact that some resources had been simplified and moved to the UK in the meantime.

This resulted in the previous guidance to wait another three to five years before retirement changing to a more positive “Yes, you can retire if you are comfortable with the shape of your income in retirement”. This was greeted with delight and relief, but not immediate action.

It does appear that the knowledge that retirement is possible is the most important thing to clients. I suspect that they will soon tire of early morning starts to catch flights all over the world, reality will set in, and their dream of retirement will eventually come about. ●

### A NOTE ON CURRENCY EXCHANGE VOLATILITY

We are all familiar with setting out our assumptions when creating a financial plan: inflation, asset growth and charges, for example. But it’s also important to set out currency exchange assumptions. This not only includes the actual exchange rate used, but what risks the clients are taking based on potential volatility in exchange rates.

But in this case, as in others, we find that what in the UK makes sense – defer drawing a pension, and see the resulting payable income rise by a few percentage points, for example – can be stood on its head as a strategy when currency is considered.

It does not take many 10% overnight type swings to wipe out a few years of slow and steady gains.

ILLUSTRATION: ISTOCK



A LACK OF IT EXPERIENCE AMONG STAFF AT FINANCIAL PLANNING XYZ HAS LED TO A NEW APP UNEXPECTEDLY COLLECTING CUSTOMER DATA FROM THEIR DEVICES. DOES THIS CONSTITUTE A DATA BREACH, AND WHAT SHOULD DANNI, THE CEO, DO NEXT?

# Knowing your clients too well?

**D**anni is the founder and CEO of Financial Planning XYZ. She has always been adamant that knowing her customers is the key to her success, and it seems to have paid off. She now employs 56 staff members over three offices in Birmingham, Liverpool and Manchester, with more than 400 clients.

Every year, Financial Planning XYZ conducts a customer satisfaction survey. In previous years, surveys have been sent out by post, and clients have returned them anonymously. However, Danni and her executive team, consisting of the heads of the three offices, finance director and HR director, agree the business needs to modernise, and decide to develop an app which their customers can use to complete the survey and submit feedback.

Start-up firm Easy as ABC, which specialises in creating apps for small businesses, is appointed to build the app. The most attractive part of their pitch had been their simple ‘back-end’ platform, which they promise is simple enough for even a tech novice to use to edit content. Development progresses quickly, and Danni and her team are pleased with its intuitiveness for clients, its simple system interface, and especially its functionality of downloading survey responses directly onto the Financial Planning XYZ servers.

Once development and testing are complete, control of the app is handed over to Financial Planning XYZ to finalise and

input the customer survey questions.

Meanwhile, most of the staff at Financial Planning XYZ are busy preparing for the implementation of the General Data Protection Regulation. So, the head of HR, Mike, suggests hiring an intern to assist with the app launch. This is agreed, and Sam is hired for a month. He is young, enthusiastic, and reassures Mike that he knows exactly what is needed, having assisted with similar data collection via an app before.

The app launch goes better than expected, and responses from customers start pouring in. But Danni is confused when Sam approaches her and asks what he should do with a couple of specific questions that have been received from Mr Smith. Danni asks how he knows the questions were submitted by Mr Smith, and Sam replies that the information has been saved straight into Mr Smith’s folder.

Danni is worried, and investigates further. She is dismayed by what she finds – not only are the responses not anonymous, but each client’s response has been downloaded, in full, into their files. Furthermore, some clients have clicked ‘yes’ to a standard pop-up asking if the app could access their camera roll, contacts and location services, and therefore some personal data has also been stored in their folders.

Easy as ABC explains to Danni that the download functionality was built in because they were told it was for a customer satisfaction survey, but this needed to be activated in the back end.

// NOT ONLY ARE THE RESPONSES NOT ANONYMOUS, BUT EACH CLIENT’S RESPONSE HAS BEEN DOWNLOADED, IN FULL, INTO THEIR FILES //



Visit CISI TV to view this dilemma narrated by Sir Alan Yarrow, Chartered FCSI, former chairman of the institute, and earn 30 minutes CPD.

It transpires that Sam, put in charge of inputting the survey questions, had selected to collect the full amount of data after Mike told him how important it was at Financial Planning XYZ to know as much as possible about their clients.

None of the clients have complained about being asked for permission to access their camera roll and location services. Although the app never said that the survey was anonymous, there was an option at the end to leave their name. Some clients did so, but most did not. Additionally, some clients clicked 'yes' to the pop-up but did not leave their name, and vice versa.

### How should the firm handle this dilemma?

- A.** All the data collected by the app should be deleted. A message should be sent to the clients from Danni noting that there was an unexpected technical glitch, no erroneous data will be retained, and that clients should delete the app from their devices. The survey questions should be sent out again by post.
- B.** Each client must be informed immediately about exactly what data has been accessed. These responses should be tailored to each client, especially for those who clicked 'yes' to the pop-up, therefore giving consent for the app to access their wider personal information.
- C.** All personal data should be deleted, even if the client consented to the pop-up request, but the responses from the survey questions can be kept in the client folders, since they can be used to improve customer service and fix small problems experienced by individual clients.
- D.** The responses to the survey should be anonymised by deleting names and moving information from client folders into a central 'survey' folder. Where consent was given, some personal information, such as location, obtained by the app can be used. However, the information should only be used for its intended purpose, and its use should be reasonable and proportionate, and any unnecessary information should be deleted. ●



**WHAT WOULD YOU ADVISE?**  
Visit [cisi.org/kyc-data](https://www.cisi.org/kyc-data) to share your views. The survey results and CISI's opinion will appear in the Q1 2019 print edition of *The Review*.

## World tour: The verdict

**This 'Grey matter', about sexual harassment in the workplace, was originally published in *The Review* in July 2008, and updated and reworked for the Q3 2018 print edition.**

**With the rise of the #MeToo and #TimesUp movements, CISI asked members to consider whether they would recommend doing things differently.**

**Suggested solutions and results are as follows:**

- A.** Go back to the chief executive once he returns to the office, even though this could mean that Henry's bad behaviour continues unchecked on the current visit. Let Stephanie know what he plans to do, and encourage her to not say anything publicly until he has had a chance to speak with the chief executive again. (7%)
- B.** Report the matter to the HR director as the senior staff member for personnel issues, which this has now become. Let the HR director know that the matter has been reported to the chief executive, but that nothing (to his knowledge) has been done. (58%)
- C.** Report his concerns to the chairman, and advise the chairman of the previous report to the chief executive. The chairman is, after all, the only person who has the power to dismiss a NED. (19%)
- D.** Email the chief executive while he is away, letting him know that another report has been received about Henry's unacceptable behaviour, and that if nothing is done, the staff member concerned will almost certainly make her accusations public on social media. (16%)

We received 221 responses.

The majority of respondents recommended taking direct and urgent action (B), informing HR of the inappropriate behaviour exhibited by the recently appointed NED, despite the fact that doing so would expose the CEO for not taking the matter further. In fact, one respondent recommended going further, stating: "I would let Stephanie know what I had done, and also email the chief executive to tell him that I had made a report to HR and that Stephanie had been offended."

The second most popular option (C) also involved escalation.

Given the current focus on inappropriate behaviour and harassment in the workplace, it is heartening that respondents to this dilemma recognise the importance of escalating these matters, and that the majority chose options which would best support the victim.

Of course, we want employees to feel safe at work, and not be exposed to inappropriate or threatening behaviour. However, should a situation like this occur, we agree with the majority and recommend reporting the issue to HR at the earliest possible opportunity.

Should you wish to suggest dilemmas for future editions, please contact us at [ethics@cisi.org](mailto:ethics@cisi.org)

# FCA investigations – the new world

CONDUCT, CULTURE AND COMMON SENSE ARE INTRINSIC TO REGULATORY COMPLIANCE IN FINANCIAL AND NON-FINANCIAL CONDUCT IN FINANCIAL SERVICES. TWO EXPERTS OUTLINE SCENARIOS FROM BOTH SIDES

One of the most viewed videos on CISI TV in 2018 features an exciting interactive event on the new world of FCA investigations. This was developed with lawyers from Willis Towers Watson and two law firms, Brown Rudnick LLP and Mishcon

de Reya, who have particular expertise in regulatory investigations. A rerun at the university of Edinburgh Business School in October drew out yet more concerns for members in this sensitive and increasingly difficult area. Here, Francis Kean, a lawyer

and an executive director in Willis Towers Watson's FINEX Global, outlines some of the key issues. Opposite, Richard Burger, a partner in law firm DWF and co-chair of the CISI's Disciplinary Committee, considers some of the cultural issues.

The seminar looked at the challenges arising from the FCA's new enforcement policy and its focus on individual accountability. Adam Epstein and Guy Wilkes of Mishcon de Reya described what we aimed to achieve thus:

"The underlying law and rules are laid out in black and white. By contrast, what we were particularly keen to get across in the discussion were the critical strategic and tactical issues that people may not have thought through or, in many cases, not even have been aware of. Those caught up in potential difficulties need to take the right decisions at the outset."

The seminar was based on a realistic set of circumstances invented by our panel and staged on the podium by five actors.

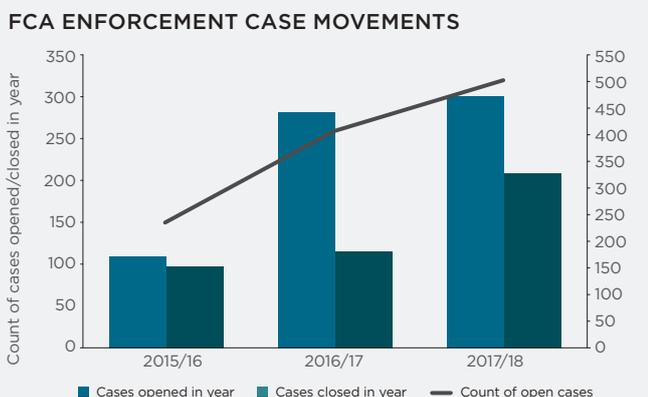
## Setting the scene

The story concerned Financial Engineering Solutions (FES), a relatively successful, middle-ranking and privately-owned asset manager with a predominantly retail client base. Its new CEO wanted to outsource as many functions as possible to free up resources in order to expand the client base by offering 'new and exciting' investment opportunities. He suggested to his COO that she should take this project forward and consider using an outsource company he had heard good things about. She then assembled an executive team comprising the head of compliance, the general counsel and the IT and operations manager, to run the outsourcing project, which resulted in the appointment of the CEO's choice as outsource company.

Several months later, after the new arrangements had been up and running for some time, the FES risk committee (comprising the same executive team) became aware of an IT-related glitch and of some customer complaints which appeared to relate to delays in administration. These were perhaps linked to the IT problems, but there was also the suggestion of some more serious issues relating to the investment products themselves. Recriminations between the executive team began to break out.

## The audience opinion

At the February event, over 200 delegates drawn from financial services organisations were given the opportunity to express their opinions through instant voting technology on a range of subjects related to this scenario as the panel debated the issues in more detail. There were some evident differences in opinion/



Source: Brown Rudnick; Financial Conduct Authority

SEE CISI TV FOR THE FULL STORY ON THE NEW WORLD OF REGULATORY INVESTIGATIONS

emphasis between the audience and the panel, of which the following were particularly interesting:

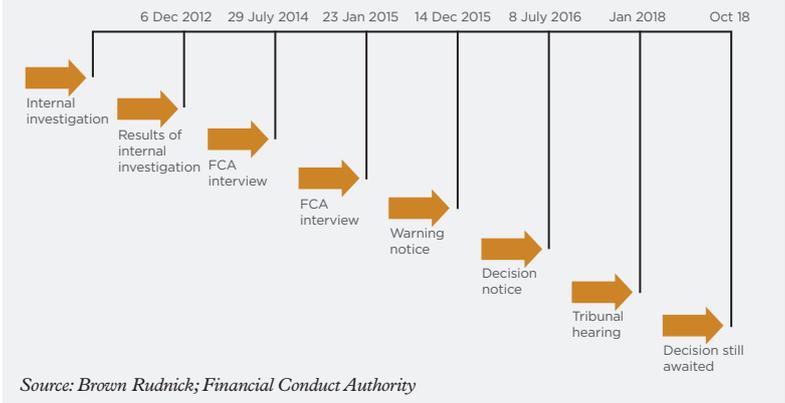
- ▶ 70% of the audience felt the CEO should be more concerned than any other employee as to the possible consequences of what had gone wrong at FES.
  - The panel, while not discounting the dangers for the CEO, were able to identify areas of concern for the whole of the team engaged in the project.
- ▶ 62% of the audience thought that FES should be notifying the possibility of regulatory breaches to the FCA straightaway.
  - The panel felt that it would be wiser to scope the problem first and go to the regulator with a plan of action.
- ▶ 66% of the audience thought that directors and other employees had the right to receive legal advice or representation at the company’s expense.
  - The panel highlighted there was no such right.

**Key issues**

Other topics the panel grappled with, under the chairmanship of George Littlejohn MCSI, were:

- ▶ Whether legal advice and/or the product of any internal investigation conducted by FES was protected from disclosure by privilege.
- ▶ What some of the strategic and tactical considerations of dealing with the regulators and the potential customer complaints might be.

**RECENT FCA ENFORCEMENT CASE**



- ▶ Some of the practical steps that should be taken and errors which should be avoided by FES in dealing with the issues.
- ▶ The potential conflicts of interest between FES and its employees.
- ▶ Who should pay and whether and to what extent a Directors & Officers liability policy could be relied on. ●



**FCA investigations – the new world is available on CISI TV now.**

**Quick quiz answers:**

1.B, 2.A, 3.A, 4.B

**COMPLIANCE, CONDUCT AND CULTURE: NON-FINANCIAL CONDUCT IN FINANCIAL SERVICES**

**Richard Burger, Chartered FCSI, partner, DWF LLP, and joint chair of the CISI Disciplinary Panel**

Recent commentary from the FCA on non-financial conduct and culture in firms highlights the regulatory expectation on firms to: “foster healthy cultures which support the spirit of regulation in preventing harm to consumers and markets.”

With a specific focus on sexual harassment, the FCA “views sexual harassment as misconduct which falls within the scope of [its] regulatory framework.” It says: “A culture where sexual harassment is tolerated is not one which would encourage people to speak up and be heard, or to challenge decisions. Tolerance of this sort of misconduct would be a clear example of a driver of poor culture.”

Firms should not be surprised if the regulator now takes an interest in how senior management responds to and investigates allegations of sexual misconduct and poor personal misconduct. In such non-financial conduct reviews, typically at the request of the regulator, a senior figure such as an independent non-executive director (INED)

will be tasked, with some external support, to review the conduct and culture of a firm. Examples include reviewing a firm’s approach to compliance following a complaint received by the regulator that a senior director, at a firm’s Christmas party, had shown “little regard” for the firm’s compliance function and for the regulator. In another case, where the regulator had real concerns that senior management were overstretched and “stressed out”, there was a “less than warm welcome” for the regulator at a routine supervisory meeting, involving the phrase “not you lot again”.

By the time the Senior Managers and Certification Regime rolls out across all financial services, all senior individuals, and those wishing to achieve senior manager status, should be aware of their regulatory responsibilities and individual accountability, including a positive obligation to appropriately and proportionately notify the regulator of conduct rule breaches. Firms should provide sufficient whistleblowing and internal complaints handling procedures so staff can report concerns and feel they have a voice within firms.



**FRANCIS KEANE**  
Executive director, FINEX Global, Willis Towers Watson



**RICHARD BURGER**  
Partner, DWF



# Ask the experts:

## Insurance Distribution Directive

The Insurance Distribution Directive (IDD) introduces a pan-European regime that harmonises regulation of insurance distribution activities across the single market, to improve consumer protection standards and promote a single market for insurance sales. While these obligations are not entirely new to UK firms, the IDD is much more prescriptive. Bovill's **Umar Mohamad** explains

### What's changing?

There are a number of organisational changes for wealth managers or IFAs to consider as an insurance intermediary. Here are the top eight.

### What are the new knowledge and ability requirements?

IDD requires distributors and their employees to have appropriate knowledge and ability (the minimum requirements include knowledge of policy terms and conditions, applicable laws, claims and complaints handling, and ethics standards), demonstrated by completing a minimum of 15 hours per year of CPD.

### What record keeping is needed?

IDD will require the adviser to establish and maintain appropriate records to demonstrate their compliance with the employee knowledge and ability requirements.

### Professional indemnity insurance

The IFA will need to review the level of their professional indemnity insurance (PII) to check it is in line with the requirements of IDD. Minimum levels of cover are €1,250,000 per claim per year, and €1,850,000 per year in aggregate. In the UK, existing rules are more detailed than the IDD requirements in some respects. The existing rules include:

- ▶ a requirement for intermediaries to maintain a higher minimum aggregate cover – 10% of annual income up to £30m – where this is greater than the IDD minimum amount
- ▶ requirements around excess levels
- ▶ the need to have specific terms which the PII cover must incorporate (such as cover for legal defence costs and Ombudsman awards).

### Are there specific rules on client monies?

This may be applicable depending on the

structure of the IFA and whether it receives or holds money in the course of or in connection with its insurance distribution activity. If it does, then it is subject to the requirements regarding the protection of clients' money through the existing options of segregation and risk transfer contained in part 5 of the client assets and money (CASS) section of the FCA Handbook.

### What about complaints handling?

IFAs should review their complaints handling process to ensure it is in line with the requirements of IDD. The FCA Handbook DISP 1.1.10-A states: "A firm must have in place and operate appropriate and effective procedures for registering and responding to complaints from a person who is not an eligible complainant."

*“Wealth managers and IFAs will need to review their current arrangements”*

### And conduct of business requirements?

There are overarching best-practice requirements that insurance intermediaries should abide by, including pre-contract disclosures, managing and disclosing conflicts of interest, demands and needs and a general obligation to meet the customer's best interests. Here's where to look in the FCA Handbook:

- ▶ SYSC – overarching responsibility to establish and maintain systems and controls as are appropriate to the insurance distributor
- ▶ COBS – applies in relation to designated investment business (insurance-based investment products) and long-term insurance business in relation to life policies and long-term care insurance contracts that are pure protection contracts

- ▶ ICOBS – applies in relation to non-investment insurance contracts, (that is, general insurance contracts or pure protection contracts that are not long-term care insurance contracts).

### How do the rules affect the Insurance Product Information Document?

The adviser needs to be comfortable that the information provided to customers meets the IDD requirements. See ICOBS 6 Annex 3.

### How do the rules affect product governance?

The adviser will need to review their current product governance framework and amend it for the distribution of insurance products and the requirements of IDD. The product manufacturer must provide the adviser with information relating to the product's approval as well as any additional information from later reviews to have confidence that their products are being distributed in line with their expectations. This is covered in greater detail in the FCA Handbook under PROD 4.

### What will I need to do now?

So, while the IDD obligations are not entirely new, wealth managers and IFAs will be subject to much more prescriptive requirements. They will need to review their current arrangements, enhance current processes, and increase oversight and record keeping. ●

**UMAR** is a regulatory consultant at Bovill, the financial services regulation specialists. He has also held in-house compliance roles, including for a large US insurer. His experience spans governance and controls, conduct risk, compliance effectiveness and data privacy across insurance, pensions and investment management. He can be contacted at [umohamad@bovill.com](mailto:umohamad@bovill.com)

“

We're all justly proud of our National Health Service (NHS) in Britain – has the time come for us to create a National Wealth Service, open to all and free at the point of delivery? ”

*Andrew Davis, p.66*

A white signpost with a blue rectangular logo containing the white letters 'NWS' in a bold, sans-serif font. The signpost is set against a background of a clock tower and bare trees.

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## FROM THE EDITOR

THIS SECTION PROVIDES REGULATORY AND STRATEGIC INFORMATION FOR SENIOR MANAGERS OF FIRMS. IT DESCRIBES THE POSITION AS AT 5 NOVEMBER, EXCEPT FOR THE BREXIT SECTION, WHICH WAS UPDATED ON 20 NOVEMBER. THE REPORT CAN ALSO BE ACCESSED AS A PROFESSIONAL REFRESHER AT [CISI.ORG/PR](http://CISI.ORG/PR) OR LOG IN TO MYCISI.

**CHRISTOPHER BOND**, CHARTERED MCSI, EDITOR, REGULATORY UPDATE, [CHRISTOPHER.BOND@CISI.ORG](mailto:CHRISTOPHER.BOND@CISI.ORG)

### GENERAL REGULATORY CHANGES

#### 1. Brexit

It is unclear as of 20 November whether there will be a 'no deal' Brexit, so EU and UK regulators are giving more information to firms on a possible one. The European Securities & Markets Authority (ESMA) has issued a letter which accepts that national EU regulators have power to approve third country firms doing business with eligible counterparties and per se professional clients without being subject to Markets in Financial Instruments II (MiFID II) or EU regulation. However, it

proposes that the EU framework on this needs "further improvement", specifically that MiFID II and EU supervision should apply and the reverse solicitation

regime (when the EU customer initiates the transaction) should require the third country firm to prove that it did not solicit the order, and that the client could request EU law for the transaction rather than third country law, eg, English law. The timetable for these changes is unclear but the direction of travel in restricting these popular routes is clear. Helpfully, US regulators are also challenging this plan. The European Central Bank (ECB) has warned EU banks that they have a maximum of three years to reduce their use of 'back-to-back' booking of loans and transactions between the UK firm and its EU group company.

The FCA has published its own plans to keep the EU rules in place. There will be some changes to the prudential, conduct of business and trade reporting standards, but EU guidelines and recommendations will continue as UK ones. The FCA has said there will be "no bonfire" of EU rules. There is some short-term comfort for EU firms doing business in the UK – if they have notified the FCA. However, the ability to continue to service UK clients depends on their home state EU regulator, many of

whom have provided no guidance. Some have suggested that a no deal Brexit would give the FCA the opportunity to impose more specific regulation, rather than less.

There is much focus by regulators and firms on clearing. The change of heart by the EU Commission that derivative transactions by EU firms can be temporarily cleared by UK clearers has been welcomed by the UK and LCH. EU regulators would like continued access to UK clearers. ESMA said: "To respond to these risks in financial stability in EU

// THE BOE  
 ESTIMATES THAT  
 £38tn OF TRADES  
 ARE AFFECTED //

financial markets, we need to ensure continued access to UK clearing houses for EU clearing members and trading venues."

(This was a huge concern. The Bank of England (BoE) estimates that £38tn of trades are affected, including 90% of euro denominated interest rate swaps. Where clearing is done, trading may well follow, given the close relationship between the two. For example, EU banks were and may still be considering moving their trillions of pounds worth of derivatives positions to EU centres, the US or Asia. One EU bank said: "If there is no transition period agreed in December, you will see the derivatives markets acting already ... it does not happen on 1 April."

Much the same applies to UK entities reporting trades to regulators on behalf of EU clients (and vice-versa).

#### 2. Corporate governance and audit

The UK regulators have made the importance of operational resilience clear to firms. This follows a litany of problems in IT failures, data protection breaches and inadequate cyber defences. Both global banking regulators and the BoE have moved on from prudential regulation to operational resilience; and this applies to investment

firms as much as to banks – note the continuing woes of the platform sector. Expect increasingly large penalties on firms who have these problems, in addition to the regulators requiring appropriate compensation to clients and individual responsibility of senior managers under the Senior Management and Certification Regime (SMCR). It is likely to be in supervision visits, and should be regularly discussed by boards.

### 3. Financial crime

Money laundering, sanctions breaches and market abuse monitoring are the top current focus areas. As more information becomes available on the huge Danske Bank €200bn volume of suspicious transactions, the bank and its regulators face the threat of being refused access to the dollar market in the US (or a multibillion dollar fine) and regulatory investigations in Denmark, Estonia, Finland, the UK and Switzerland. Even national EU regulators are in trouble. The European Banking Authority (EBA) has criticised Malta's "general and systematic shortcomings" and has ordered it to tighten its enforcement of EU anti-money laundering (AML) rules, giving the ECB new powers to do so.

The US continues its campaign against breaches of Iranian sanctions now that it has withdrawn from the Iranian Treaty. It is focusing upon alleged breaches by Standard Chartered Bank. Any UK firm with US business should take careful note even if the EU has withdrawn its sanctions.

The FCA's priority of ensuring that firms monitor transactions for market abuse continues. The large fine on a firm for relying mostly on an unregulated service provider to do so (even though there was no abuse) shows that a firm must identify the risks and manage this monitoring itself. Previous guidance makes it clear that automatic checking of all transactions is the preferred method. A firm would need to demonstrate to the regulator that manual checking is proportionate to the volume of trades and that it is sufficiently regular and frequent.

### 4. The FCA's other initiatives

Apart from focusing on a potential 'no deal' Brexit, the FCA continues to encourage firms to start their preparations for the SMCR. David Blunt,



Visit *The Review* online to read what FSCS chairman Marshall Bailey OBE has to say about the 'thorny issue' of the levy



head of conduct specialists at the FCA, said: "It is never too soon to start. The clarity of responsibility you must then articulate in statements will help you run your business better." This was followed by a strong hint to firms to discourage them from appointing sales individuals as senior managers: "Take the opportunity to think about who is in the top team. Are sales people who have risen to the top the right people to be leading? There is an opportunity for the firm to make changes." Given that regulators approve all senior managers already and that the main purpose of the SMCR is to make all senior managers more accountable, if they distrust a particular sales manager,

they should surely take action – or simply not approve them.

The FCA appears to be using the SMCR to promote its other initiatives. It has brought sexual

harassment into firms' application of the 'fit and proper' test to certified staff. Understandable, but also a warning that the regulator may advance its policies by limiting which staff firms can approve.

Another idea the FCA is exploring is a switch to digital reporting by firms to it. The current system, GABRIEL, has been criticised as too inflexible, prone to reject entire reports for procedural reasons (an inapplicable box left unticked), limited in capacity, requiring considerable interpretation and sometimes unavailable. Some firms have cautiously welcomed the FCA's idea, but concerns remain in smaller

firms and those with memories going back to the introduction of GABRIEL.

### 5. The FOS and the FSCS

The FCA is proposing to increase the maximum award the Financial Ombudsman Service (FOS) can make, from £150,000 to £350,000 for problems arising after 1 April 2019. The FCA explains that this is because many claimants are not receiving full compensation, including under the extension of the FOS regime to smaller SMEs. The treatment of SMEs by the RBS turnaround unit may be relevant. Some individual financial advisers are concerned that this may drive up professional indemnity premiums to the point that they will leave the profession.

The FOS case review process continues to be criticised. Nicky Morgan, chair of the powerful Parliamentary Treasury Select Committee, said of the FOS proposed internal review of old cases: "It is also concerning that cases will be tested against the 'Wednesbury reasonable test', that is the Ombudsman decision would have to be considered irrational as well as unreasonable. This is an extremely high bar as decisions can be poor without necessarily being Wednesbury unreasonable."

The Financial Services Compensation Scheme (FSCS) has a new chairman, Marshall Bailey. He will need to address the firms' considerable unhappiness about FSCS levies to pay for the compensation. The main one is that well run firms pay levies for the bad advice given by poorly run ones – which the firms did not choose to insure or supervise. The outgoing chief executive, Mark Neale, rebutted this argument: "Although I understand the compensation costs are unwelcome, the fact that the

// THE NEW  
FSCS CHAIRMAN  
WILL NEED TO  
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ABOUT FSCS LEVIES  
TO PAY FOR THE  
COMPENSATION //

safety net exists is good for the sector as a whole because it underpins confidence". IFAs are particularly critical because many claims from historical bad advice remain.

**SECTOR CHANGES**

**5. Private wealth management**

The main focus has been on platforms. The continuing saga of Aviva and Aegon re-platforming clients has led clients to be locked out of their accounts for a month or more. This is bad at any time, but particularly in volatile markets. A number have complained to the FOS already and/or moved their clients' assets. The platform's costs in rectifying problems can be as much as £3m a month. Many advisers are reconsidering their reliance on platforms that migrate clients. The FCA has also been focusing on platforms for some time, rightly seeing that they are becoming a systemic risk. Its full platform study is due out in 2019 and this will address not only re-platforming but the often long delays faced by individual clients moving investments in specie to a new platform. The more positive aspect is that platforms receive a lot of data which is valuable about their clients' behaviour, which could be used to predict funds' popularity, even model portfolios. Gathering more information about their clients will also help them to provide more information about the nature of the ultimate client to fund providers under product governance rules in MiFID.

There is another concern for platforms. The courts have recently considered the key question of whether a self-invested personal pension (SIPP) provider has the duty to do due diligence on the suitability of investments requested by a SIPP client and refuse to execute it if appropriate. In

the case of SIPP provider Berkeley Burke, the FOS said the platform did have this responsibility, and the High Court confirmed this: "Any suggestion that a SIPP provider must, as a result of COBS11.2.19R, execute a transaction, regardless of the duties contained in the Principles [which include the client's best interest] produces surprising results and in my view cannot be right". The FCA has now written to SIPP platforms asking them whether they have sufficient funds to meet similar claims. The firm had argued that the Pensions Regulator had previously held they had no such duty.

Contracts for difference (CFD) platforms have additional problems. The FCA and ESMA are both discouraging platforms from marketing to retail customers and in trying to avoid the

crackdown through using non-EU subsidiaries. Leading platforms have seen big profit falls. FCA mystery shopping continues around firms' cost and

// ONE DEVELOPMENT TO WATCH IS OPEN BANKING, UNDER WHICH A CUSTOMER GIVES ACCESS TO THEIR PERSONAL INFORMATION TO CHOSEN FINANCIAL PROVIDERS //

charges' disclosures under MiFID II. It wants firms to make comparable disclosures and trade bodies' guidance is a valuable resource here. Andrew Bailey, FCA CEO, has said that the FCA will start to hold firms to account if they do not adequately disclose all costs and charges accurately, eg, including rebates and discounts.

The struggle between high street banks and private wealth managers on advice and wealth management took a new turn when a bank (Lloyds) and a

manager (Schroders) linked through a joint venture focusing on this.

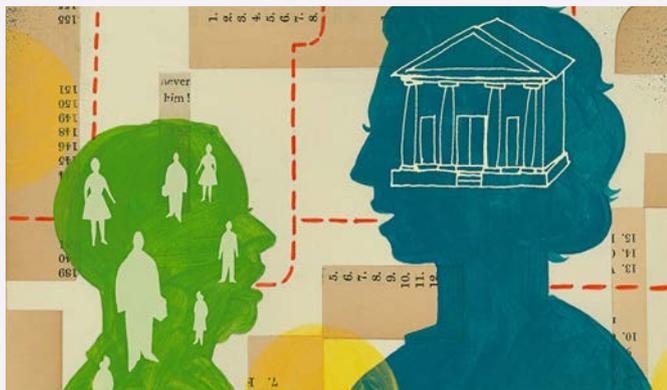
One development to watch is open banking, under which a customer gives access to their personal information to chosen financial providers. This could revolutionise onboarding of clients by managers because they would have access to stored due diligence documentation. So far there has been limited take up.

Nutmeg has introduced a new fee model for financial advice. It will charge a free initial consultation followed by a fixed fee of £350 if the client wants a specific recommendation. It claims this is much less than the £1,000 to £4,000 annual retainer which other advisers charge.

**6. Asset management**

Many developments:

- ▶ A Morningstar long-term study (over ten years) has shown that European active managers have been clearly outperformed by passive managers (in 47 out of 49 sectors). The survey was EU-wide with over €2.9bn in assets. A separate report from CEM Benchmarking found that transaction fees accounted for 25% of cost of investing in large portfolios. Further reason for the FCA to push against closet index managers and management fees in active funds in general.
- ▶ A leading accounting firm has forecast that actively managed fund fees will reduce by 20% by 2025, which equates to an asset weighted average of 58 basis points from 78 basis points currently. It also foresees new marketing practices, such as early bird discounts and loyalty rebates, and that passively managed funds will see a 36% reduction in fees to 15 basis points.
- ▶ Brexit continues to be the top priority of many firms with EU clients. Uncertainty continues as to how to continue to service and market to them. Some hope that there will be acceptance by both the UK and EU regulators that firms can continue to do this even if there is no deal; others plan for the worst and are setting up parallel funds in Luxembourg or Ireland. The position of EU managers' branches in the UK is better since the FCA has indicated it would like them to continue for three years - but the choice is dependent on the home state regulator of the head office.
- ▶ Pressure is on managers investing pension funds' assets to take account of climate change in investing. The FCA



Visit *The Review* online for our article on the rise of open banking in the UK



has published plans to make sure providers of work place personal pensions take climate risks into account and to disclose their policies on it.

- ▶ The FCA has also proposed that property funds should suspend trading in their securities if there are questions about 20% of its 'hard to sell' assets. In the past, funds managed by Standard Life, Aviva and M&G did this to avoid remaining investors being disadvantaged. The power to suspend will be disclosed to investors.
- ▶ The Investment Association (IA) is asking the FCA to suspend the introduction of packaged retail investment and insurance products (PRIIPS) for investment trusts and in future for open-ended investment companies (OIECs). The IA argues that the formula for disclosing costs and charges is "fundamentally flawed" because many managers are showing zero or negative transaction costs (and the formula for past and future returns).

## 7. Pensions

Pensions have been a strong focus of regulatory interest to IFAs, private wealth managers and asset managers, given the government's desire to increase saving. High street banks are competing with IFAs to advise investors. Here are some key points:

- ▶ The government's proposal for a pension dashboard in 2019. This would enable the public to see all their different pension pots in one place so they can plan their retirement. The data would be supplied by pension providers who would also keep it up to date. This would be a voluntary duty.

The principle has been widely welcomed but some have severe doubts that all providers will be willing to do this, given the potentially considerable cost of doing so and the possibility of increased transfer activity. The government itself has not decided whether and how to migrate state pension

information (which is key given that the pension is more than half the income of median and low retirees); and the possibility of fraudulent providers accessing sensitive data.

- ▶ The FCA and trade bodies are encouraging pension providers to adopt a new two-page annual statement for their members. The

// ONLY 30% WILLING TO SACRIFICE SOME PROFIT FOR SOCIALLY RESPONSIBLE INVESTING //

FCA is conscious that the cost of obtaining PI cover may drive smaller firms out of business.

## 8. Ethical investing

The trend towards this is well known.

Here are some of the impacts:

- ▶ The generation gap. Older investors are more likely to put profit before ethical



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investing. A venture capital trust (VCT) provider, Albion, surveyed 250 individual investors aged between 40 and 80. Only 30% were willing to sacrifice some profit for socially responsible investing. Where they would, healthcare, environment and infrastructure were favoured. By contrast, a YouGov survey of investors between 20 and 40 found that 40% of millennials understood ISAs, 20% bonds and equity, with 21% saying they were already using, or would be likely to use, a free online platform to manage their investments. This coincides with the transfer of wealth to millennials on a large scale as 'baby boomers' retire. (US Trust estimates that US\$12tn will be handed over in the next ten years.) The survey also found that no less than 75% of wealthy millennials "consider the social and environmental impact of the companies they invest in to be an important part of decision-making". Traditional fund houses should be planning for this if they have not already done so.

- ▶ From October 2019, pension fund trustees who disregard the long-term financial risks or opportunities from ESG will have to justify how this does not hurt investment returns under new government rules.
- ▶ One area of ESG or SRI investing is impact investment - which measures the social impact of the investment. It is becoming popular where results can be measured. Often the investment is in a social not for profit enterprise. Sometimes the investment is a gift; other times it is at a below market return; and it can be a commercial one with the return depending on the success or failure of the investment.

*Views expressed in this update are those of the author alone and do not necessarily represent the views of the CISI.*

## RETHINK EVERYTHING? THE NEXT GENERATION'S CALL TO ARMS

"A new generational cohort is emerging, and it's one to which markets need to pay attention." From baby boomers to 'millennials', with many generations in between, the time of the 'xennial' is upon us, according to an acclaimed and thorough new analysis, *The New Adulthood*, from marketing giant JWT. "Xennials grew up with technology but aren't necessarily digital natives," it says. Gillian Tett, US managing editor of the *Financial Times*, warns: "The next time you hear somebody arguing about millennials, tell them they should really be talking about xennials instead."

In April 2018, Mark Carney, governor of the Bank of England, warned of the "catastrophic impact" climate change could have for the financial system unless financial services firms do more to disclose the risks they might face from it.

He warned that the finance sector could be forced into making rapid adjustments, which could trigger steep losses, if firms did not gradually expose where their climate change risks might lie. Referring to the work of the economist Hyman Minsky, who argued that extended bull markets ended in large collapses, he warned of a "climate Minsky moment".

In October 2018, Britain's Prudential Regulation Authority (PRA) published a consultation paper on a draft supervisory statement which sets out expectations regarding firms' approaches to managing the financial risks from climate change.

These centre on a strategic approach which considers how actions today affect future financial risks.

"Climate change and society's response to it presents financial risks that are relevant to the PRA's objectives of safety and soundness.

// 2017 WAS A RECORD YEAR FOR CLIMATE-RELATED SHAREHOLDER RESOLUTIONS //

More [firms] need to take a forward-looking, strategic approach if financial risks are to be minimised," it says.

As Governor Carney pointed out in April, there has been a series of actions to transform climate disclosures: "2017 was a record year for climate-related shareholder resolutions, with a threefold increase in motions (184 vs 63) and with investment managers controlling over 45% of global assets under management backing shareholder actions on carbon disclosure. Several of the world's largest asset managers – including the two largest, BlackRock and Vanguard – have written to a number of public companies calling for such disclosures. Other

long-term investors have joined forces to press for disclosure through groups such as Climate Action 100+ and the International Investors Group for Climate Change. Levels of attendance at CISI events involving sustainability in 2018 have highlighted the power of a whole new group of members and clients.

### THE NEW ADULTS

'Xennials' (born 1977–1985) are a 'microgeneration' between generation X (1966–1980), and the millennials (1980–2000). The JWT report poses 'new adults' as a more representative name for "a group of 30 to 45-year-olds with more in common with each other than with any other generational label".

This issue of *Review of Financial Markets* delves into some of the issues these new adults are expecting the financial world to consider. We start with highlights from Z/Yen's latest Global Green Finance Index project. Then some highly pertinent research on green bonds drawn from the continuing excellent work on this by TheCityUK and Imperial College Business School's Centre for Climate Finance and Investment. Ahead of our annual gathering of Islamic finance professionals in London in December, Dr Hatim El-Tahir of Deloitte unveils his latest work on bringing sukuk into the mainstream, and linking Islamic finance with the issues around sustainable and responsible investment.

Professor Bill Rees and Alistair Haig ACSI of the University of Edinburgh ponder whether machines will soon replace investment analysts (adding insult to the MiFID II injury). And last but not least, reputational risk guru Anthony Fitzsimmons considers the 'dangerous delusion' of the three lines of defence model of risk management.

**George Littlejohn MCSI, editor, *Review of Financial Markets*, and CISI senior adviser.**  
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# FOCUS ON CLIMATE: TRANSITIONING TO A SUSTAINABLE ECONOMY

**PROFESSOR MICHAEL MAINELLI**, EXECUTIVE CHAIRMAN OF Z/YEN GROUP; AND **MIKE WARDLE**, HEAD OF INDICES AT Z/YEN GROUP, LOOK AT HOW FINANCIAL SERVICES CAN ALIGN MORE CLOSELY WITH THE PARIS AGREEMENT AND THE SUSTAINABLE DEVELOPMENT GOALS

The Global Green Finance Index (GGFI) project was launched in spring 2017, with the first publication in spring 2018, not just to measure how 'green' financial centres are, but to help catalyse growth in this sector, improve policymakers' understanding of what makes a financial centre 'green', and shape the financial system to support sustainability goals.

Professor Michael Mainelli, Chartered FCSI, says: "Success measures' suffer from the complexity of measuring not what level of success was achieved, but what level of success should have been achieved. GGFI allows us to see how a centre would fare without a strong reputation, based on just fundamentals. GGFI hopes to provide continuous index improvement by including hypotheses about success backed by instrumental factors to measure them."

*This article includes references to endnotes. The full list can be found online at [cisi.org/rofmq4-18](http://cisi.org/rofmq4-18)*

## THE CHALLENGE

Atmospheric concentrations of greenhouse gases have risen precipitously since the beginning of the Industrial Revolution. For carbon dioxide, the average concentration has increased from 282 parts per million (ppm) in 1800 to 412ppm in 2017.

The last time CO<sub>2</sub> levels were this high was the middle Pliocene, 3.6 million years ago. During this period, global temperatures were 2°C to 3°C higher than today.<sup>1</sup> Forests grew in the Arctic<sup>2</sup> and global sea levels were 25 metres higher than today.<sup>3</sup>

Inertia built into climatic systems means there is a lag between rising CO<sub>2</sub> concentrations and the impact on global temperatures. The full impact of carbon emissions today will not be felt for half a century.<sup>4</sup> However, if all known reserves of fossil fuels were burnt, average global temperatures would rise by 10°C,<sup>5</sup> rendering 99% of life on Earth extinct.

To survive, society not only has to transition economic growth onto a low carbon path that keeps temperature increases below 2°C; it must also adapt infrastructure and services to cope with the impacts of climate change.

## THE ROLE OF FINANCIAL SERVICES

The financial sector is a critical means for price signals, regulation and civil society pressure to create and direct financial capital to more or less sustainable economic activity.

International and regional financial institutions, finance ministries and central banks all have crucial parts to play in achieving the goals set out in the Paris Agreement and the Sustainable Development Goals.<sup>6</sup>

Financial services affect development paths in three main ways:

- pricing assets and exercising ownership
- pricing risk
- flows of finance.

Policymakers, finance ministries, regulatory agencies and central banks have an enabling role in ensuring adequate transparency and governance, providing a level playing field and ensuring a stable policy environment in which long-term investment can take place.

## ARE FINANCIAL SERVICES LIVING UP TO THE CHALLENGE?

### Pricing assets and exercising ownership

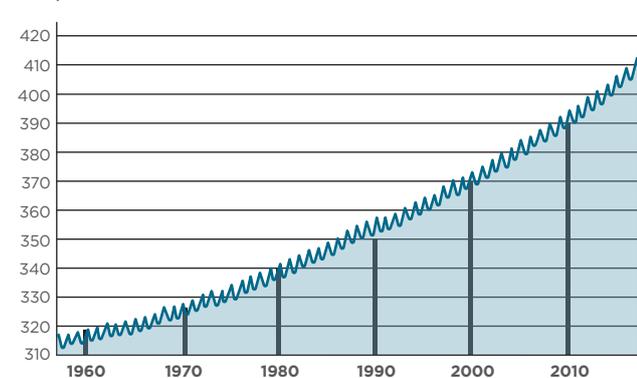
It is estimated that worldwide, 20% of all funds are now managed on socially responsible investment (SRI) principles.<sup>7</sup> Globally, there are now US\$22.89tn of assets being professionally managed under responsible investment strategies,

an increase of 25% since 2014.<sup>8</sup> Impact investment funds grew from US\$25.4bn to US\$35.5bn between 2013 and 2015. Pressure is ramping up on

// WORLDWIDE, 20% OF ALL FUNDS ARE NOW MANAGED ON SRI PRINCIPLES //

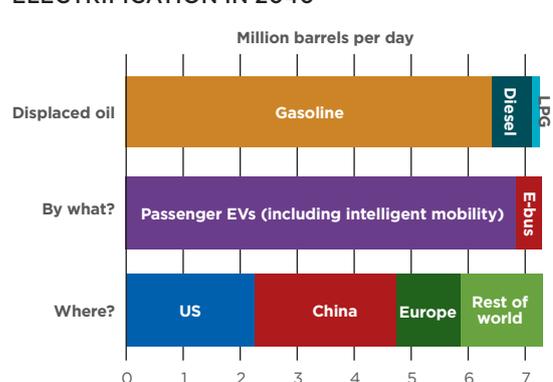
businesses. The Carbon Disclosure Project now collects information on climate risks and low carbon opportunities from the world's largest companies on behalf of over 650 institutional investor signatories with a

**CHART 1: MONTHLY CARBON DIOXIDE CONCENTRATION**  
Parts per million



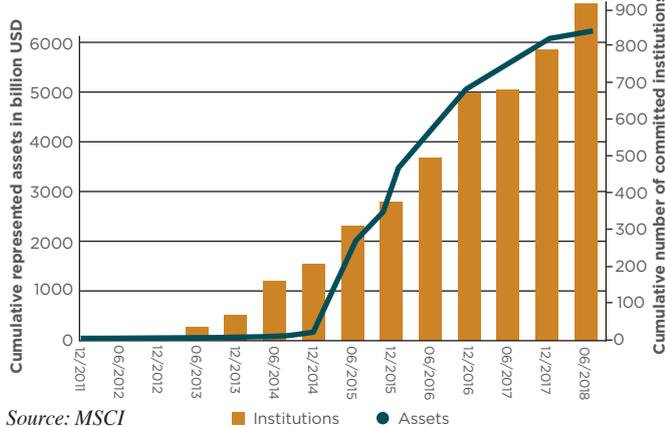
Source: <http://scrippsco2.ucsd.edu>

**CHART 2: OIL DISPLACED DUE TO ELECTRIFICATION IN 2040**



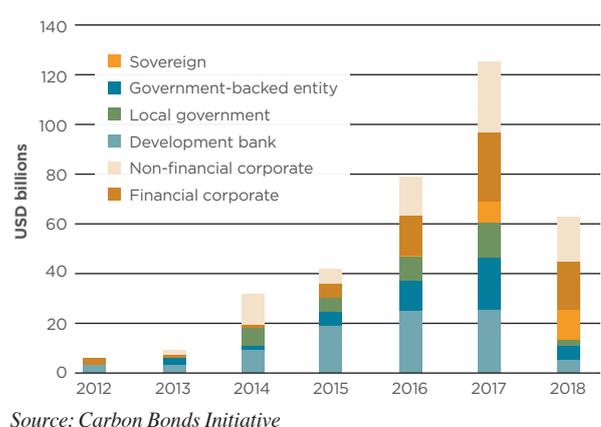
Source: Bloomberg New Energy Finance

CHART 3: GROWTH OF FOSSIL-FUEL DIVESTMENT



Source: MSCI

CHART 4: FLOWS OF FINANCE



Source: Carbon Bonds Initiative

combined US\$87tn in assets. Shareholder activism is also increasing, with pressure being placed on fossil fuel companies for disclosure of risks associated with 'stranded assets'.<sup>9</sup>

**Pricing risk**

Climate concerns and technological changes are creating new pricing risks, dramatically illustrated by the collapse in value and bankruptcies of several US coal companies in recent years.<sup>10</sup> Overcapacity, the rise of electric vehicles,<sup>11</sup> stranded assets and pricing issues are still major risks for fossil fuel and related industries.<sup>12</sup>

It is no surprise that stock exchanges around the world are embracing market transparency on climate and other impacts – 23 stock exchanges currently incorporate reporting on environmental, social and governance (ESG) information into their listing rules and 15 provide formal guidance to issuers.<sup>13</sup>

ESG analytics has long been a key tool for specialist SRI funds. Increasingly, it is being used in relation to mainstream investment analysis and is becoming a factor used by rating agencies.<sup>14</sup>

Momentum is growing on disinvestment and structured disinvestment, with a number of high-profile sovereign funds cutting their holdings in fossil fuel companies.

**Flows of finance**

The global growth of green bond markets has played a significant role in raising the profile of green finance. Globally, 14 stock exchanges now have dedicated segments for green or

sustainable bonds,<sup>15</sup> and there has been strong growth in the issuance of green bonds – with 2016 seeing the issuance of the first sovereign green bonds.

**FINANCIAL CENTRE LEADERSHIP**

While national policymakers seek to capitalise on what is perceived as a new market opportunity, through a variety of national programmes, for financial centres the emphasis is very much on

// FOR FINANCIAL CENTRES, THE EMPHASIS IS ON COLLABORATION, COOPERATION, SHARING OF BEST PRACTICE //

collaboration, cooperation and the sharing of best practice. Initiatives such as Financial Centres for Sustainability,<sup>16</sup> the Sustainable Stock Exchange Initiative<sup>17</sup> and UNEP FI<sup>18</sup> continue to provide

valuable resources which are encouraging the growth of the green finance sector.

**A MOUNTAIN YET TO CLIMB**

The transition to a green economy, required if the world is to meet the targets laid down in the Paris Agreement and avoid catastrophic climate change, is a huge global investment opportunity: the International Energy Agency (IEA) estimates that US\$26tn of additional investment is needed just in renewables and energy efficiency between 2015 and 2040 to achieve the 2°C target – around US\$1tn a year – not including the large amounts needed for climate mitigation.<sup>19</sup>

However, green finance has a long way to go if it is to penetrate and displace the enormous amounts of finance for carbon intensive activities, or 'brown finance'. In 2016, global climate finance flows were

US\$383bn, less than half the US\$1tn a year needed under the latent IEA estimate.<sup>20</sup> Only 5–10% of bank loans are 'green'<sup>21</sup> (based on data from the few countries where national definitions of green loans are available), and 'brown' finance flows all massively overshadow green finance even in the public sector: G20 countries alone received US\$72bn in annual public financing for fossil fuel energy between 2013 and 2015, and only US\$18.7bn for clean energy.<sup>22</sup>

In 1960, the carbon intensity of the world's GDP was 1,000 gr CO<sub>2</sub> per dollar. By 2000, this had dropped to 500 gr CO<sub>2</sub> per dollar. By 2010, this had reduced to 400 gr CO<sub>2</sub> per dollar. Despite this rapid progress, if we are to have any hope of attaining the Paris target of limiting global warming to 1.5°C, the carbon intensity of GDP must be below 60 gr CO<sub>2</sub> per dollar by 2050.

The progress made by the centres listed in the Global Green Finance Index is heartening, but there is a mountain yet to climb.

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**The work on GGFI was sponsored by the MAVA Foundation, a Swiss-based philanthropic organisation with a focus on biodiversity conservation.**

# GROWTH OF THE GREEN BOND MARKET

GREEN FINANCE IS BOOMING AS MARKET PARTICIPANTS, GOVERNMENTS AND REGULATORS TAP MAINSTREAM CAPITAL MARKETS TO UNDERWRITE SUSTAINABILITY

In July 2018, the Chartered Banker Institute launched a Green Finance Certificate, a new benchmark qualification that is being distributed globally by the CISI. The Chartered Banker Institute’s chief executive Simon Thompson said at the launch: “The transition to a low-carbon economy is possibly the greatest global challenge for this and future generations, with green finance playing a critical role.

“Green finance is a growing phenomenon globally and, in the UK, is forecast to continue to grow rapidly. The World Economic Forum estimates that by 2020, about US\$5.7tn will need to be

invested annually in green infrastructure, much of which will be in today’s developing world. This new certificate provides learners with a comprehensive overview and understanding of the evolving green finance sector and highlights how organisations and individuals can take an active role in supporting the transition to a low-carbon economy.”

Just before the launch of the certificate, TheCityUK and Imperial College Business School published some of their latest research on the green bond market, seeking to bring clarity to the question of what differentiates green

bonds from other types of bonds and to explore some of the supply/demand dynamics of the green bond market. This excerpt outlines some of the key results.

Full report at [www.thecityuk.com](http://www.thecityuk.com)

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Investors have been generally receptive to the green bond concept and have supported the growth of the market. The European Investment Bank – which pioneered green bonds in 2007 – is one of the world’s most prolific issuers of green bonds, with over €15bn raised across 11 currencies as of end-2016. In 2017, the US Federal National Mortgage Association (Fannie Mae) was the

world’s largest green issuer, having sold to the market US\$24.9bn of green mortgage-backed securities.

### MARKET SIZING

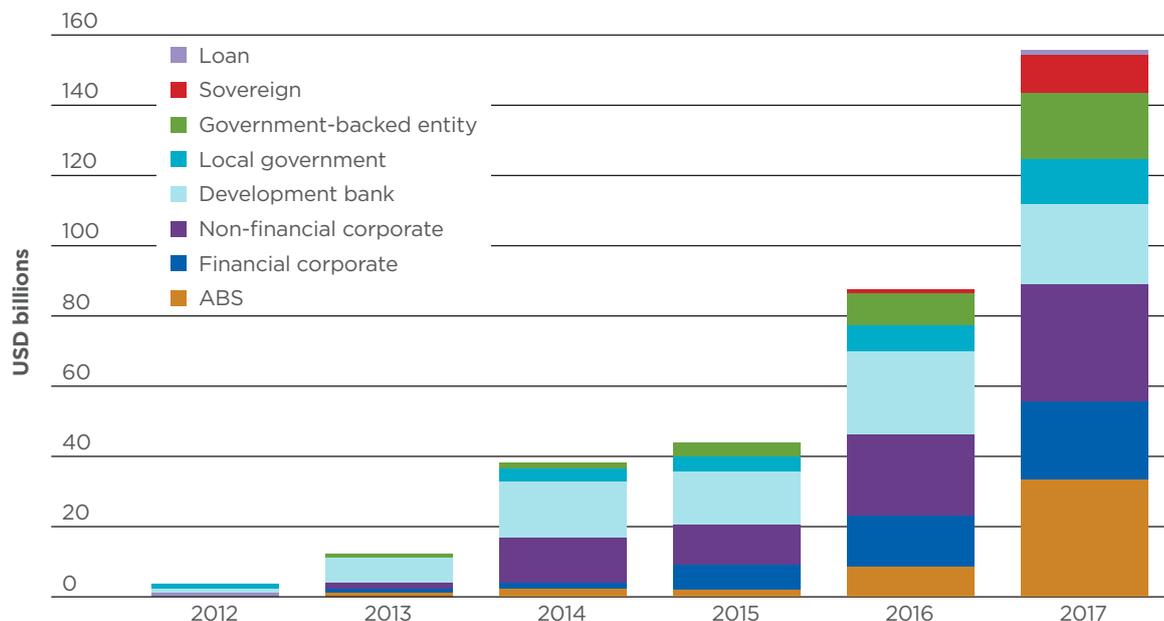
The market for green bonds has been growing robustly, although growth rates across bond types are not uniform. According to the Climate Bonds Initiative, labelled green bond issuance

rose 78% between 2016 and 2017, reaching US\$155.5bn in 2017 (Figure 1).

### GEOGRAPHICAL DIVERSITY

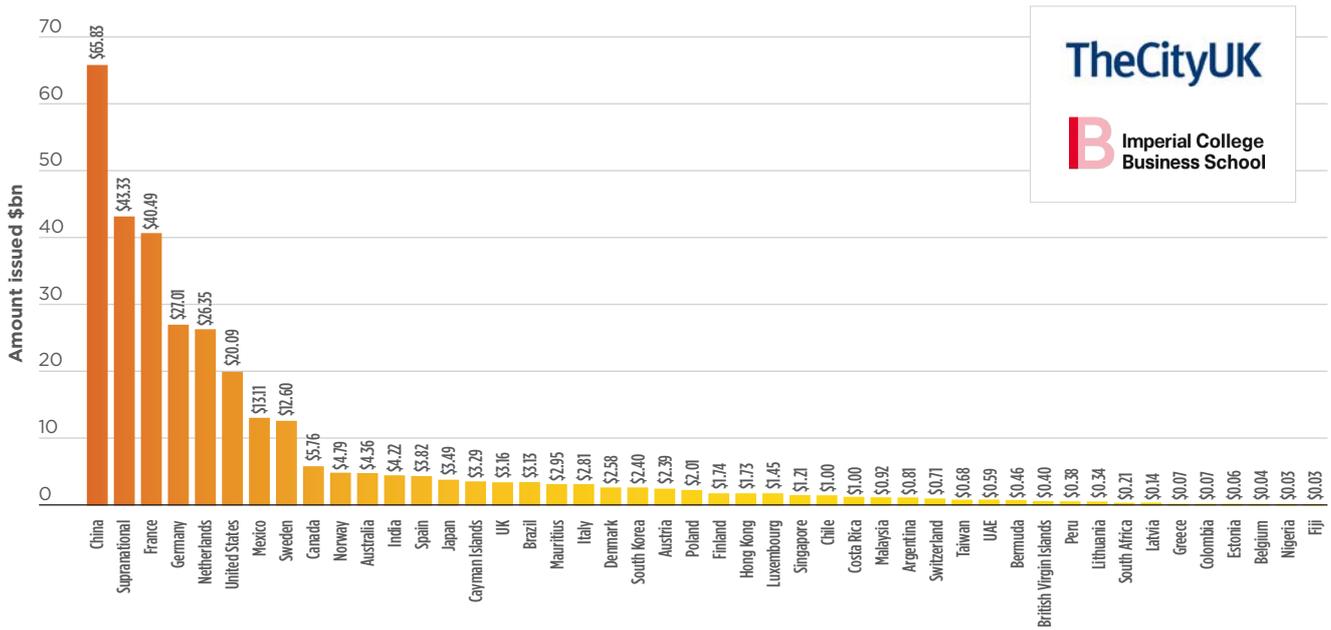
Figure 2 (overleaf) depicts the geographical distribution of cumulative green bond issuance from 2010 to February 2018. In China, the global leader, banks continued to dominate the green bond market, accounting for 74%

FIGURE 1: THE LABELLED GREEN BOND MARKET IS GROWING RAPIDLY



Source: Climate Bonds Initiative

FIGURE 2: CUMULATIVE GREEN BOND ISSUANCE BY COUNTRY FROM 2010 TO FEBRUARY 2018



Source: TheCityUK and Imperial College Business School, based on Bloomberg data

of total domestic green issuance. In France, the other leading country, the major contributor to issuance was its €7bn sovereign bond issue in January 2017, which accounted for 53% of the value of issuance from the country. However, corporates account for 32%, agencies 10%, and financial institutions and municipals the remaining 5%. The major green bond indices are usually denominated either in US dollars or euros. These two currencies combined account for 88% and 86.5% of total currencies for the Bloomberg Barclays

MSCI Green Bond Index and the BAML Green Bond Index, respectively. The pound sterling only accounts for a small proportion (5% and 4.3% of the two indices, respectively); for more information see Figure 3 below.

Most listed green bonds on the London Stock Exchange (LSE) are denominated in US dollars, euros and Swedish krona. The proportion of listed bonds denominated in sterling remains extremely low (Figure 4). In the UK, the LSE saw 27 new green bonds listed in 2017, which raised US\$10.1bn.

// INVESTORS HAVE BEEN GENERALLY RECEPTIVE TO THE GREEN BOND CONCEPT AND HAVE SUPPORTED MARKET GROWTH //

FIGURE 3: TWO EXAMPLES OF GREEN BOND INDICES

	EUR	USD	GBP	Other
Bloomberg Barclays MSCI Green Bond Index (as of 31 May 2017)	52.0%	36.0%	5.0%	7.0%
BAML Green Bond Index (as of 13 April 2017)	49.3%	37.2%	4.3%	9.2%

Source: International Capital Market Association

FIGURE 4: CURRENCY DENOMINATION OF GREEN BONDS LISTED ON THE LONDON STOCK EXCHANGE

Currency	Funds raised in national currency (millions)	US dollar equivalent of amount raised at date of issue (millions)	Number of bonds listed
US dollar	8,587	8,587	17
Euro	5,490	6,388	12
Swedish Krona	25,910	2,979	26
Pound Sterling	1,350	1,951	5
Indian Rupee	42,650	649	3
Mexican Peso	750	44	1

Source: London Stock Exchange

# SUKUK IN FOCUS: STREAMLINING INVESTMENT PRACTICES

HOW DO THE WORLDS OF ISLAMIC FINANCE AND RESPONSIBLE INVESTMENT INTERTWINE? WHAT ARE THE CHALLENGES FACING SUSTAINABLE FINANCE IN ALL ITS MANIFESTATIONS?

Sustainable finance and investment is an urgent topic, and policymakers and regulators around the world are striving to set good governance standards and common practices for this rapidly growing industry. Islamic investment bankers, policymakers and other sector stakeholders have been deeply engaged for some years in a dialogue to embrace common good practices and align leadership thinking around one common strategy – streamlining practices and aligning with global investment governance and sustainable strategies.

A key platform of this thought leadership strategy is to build sector-wide, multi-stakeholder dialogues, to create a shared infrastructure of practices and standards and harness a

more efficient, effective and seamlessly Islamic financial market structure across borders.

The 12th annual Islamic finance executive workshop, held jointly by CISI and Deloitte in December 2018 – with highlights now available on CISI TV – discussed the key challenges and opportunities for sustainable Islamic finance to achieve its promise. What does it entail? How can its impact on society be verified? What frameworks, investment governance and risk management structures should govern its products and services?

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competitiveness of sukuk as an international investment asset but also transform the way its market integrates with the global capital marketplace and serves the social and economic needs of Muslim societies. This practice improvement approach on operations, reporting and investment considerations, in our view, potentially strengthens sukuk market efficiency, increasing its viability and impact on Muslim economies and attracting international investor demand.

Three core elements are addressed in the full report: Shariah governance and sustainability; practice and market institutions; and regulatory capabilities and market development. The first two are discussed here.

## SHARIAH GOVERNANCE AND SUSTAINABILITY

### Setting the context for priority sectors

It is widely acknowledged that the primary objective of Islamic law is the realisation of its benefit to mankind by preserving and protecting five fundamental objectives of Shariah (Maqasid Al Shariah): religion (Deen), life (Nafs), lineage (Nasl), intellect (Aql) and property/wealth (Mal).

The ultimate objective of Shariah is to protect the well-being of people and nature, which lies in the safeguarding of these five fundamental objectives (see Figure 1) through the promotion of social justice. These objectives have great resemblance to the United Nations' Sustainable Development Goals

## THE CHALLENGE

Rapidly advancing technologies, increasing socioeconomic pressures, and infrastructure investments are opening doors to disruptive innovation in Islamic capital markets. It has been nearly two decades since the first sukuk on the global finance scene, yet it remains popular. However, corporates have been slow to tap into this niche market and investment bankers equally have been slow to innovate Islamic debt capital market instruments which are simple (that is, not overly complex structures with enforceability uncertainty) and have grown in size, at 19.5% of total global assets, as of 2017, according to the Islamic Financial Services Board (IFSB) Financial Stability Report for 2018.

The drive to formulate global common practices for sukuk and the wider Islamic capital market will require stakeholder collaboration to align regulatory and associated standards and practices. Furthermore, sector growth is evidently facing performance headwinds as a result of macroeconomic conditions in several markets around the world. As a result, the sukuk market landscape looks set to become increasingly divergent and segmented. Hence, it may be time to take a closer look at how sukuk, being already somewhat internationally accepted and

tested, may continue to spur growth in local economies, through practice convergence to reduce issuance frictions.

To achieve this challenging goal, it may be effective to consider the streamlining of sukuk issuance practices with international investment guidelines already in place. To assess how this proposition can be achieved, and support its merit, the following discussion will address the core elements of the global common practices in sukuk markets. Such an approach will not only help enhance the commercial

FIGURE 1: THE PRIORITY SECTORS: MAQASID AL SHARIAH ALIGNMENT TO SDGs



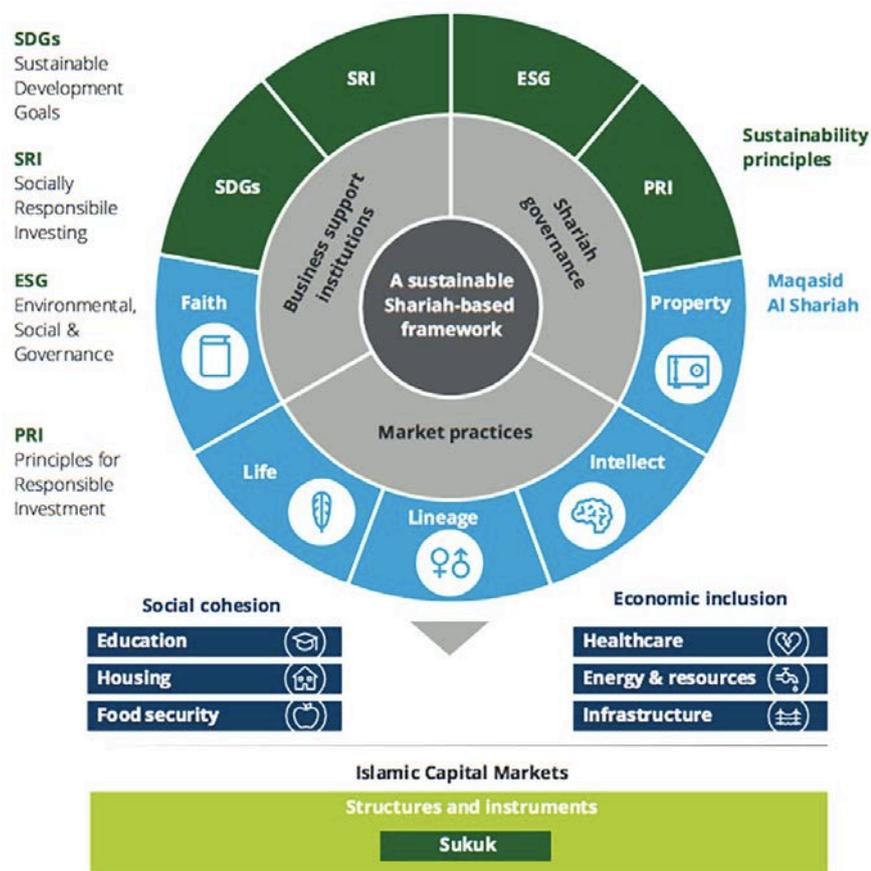
Source: Compiled by Deloitte Research and Analysis

**TABLE 1: DIFFERENCES BETWEEN RESPONSIBLE INVESTMENT AND ISLAMIC FINANCE**

	Responsible investment	Islamic finance
General investment approach	Holistic approach that aims to include any ESG information that could be material to investment performance.	Value-based approach that has mainly focused on exclusionary screens on specific social and economic grounds.
Active ownership	Strong emphasis on being active owners and to engage with companies on ESG issues (including proxy voting).	No widespread practice of engagement or active ownership.
Avoiding investment in highly leveraged companies	Not widely considered.	Sophisticated approach to analysing financial structures of corporate entities to understand cash flows and avoid investment in companies with excessive leverage.
Impact	Not widely considered, but there is a growing focus on environmental and social impacts of investments (including contributions to the SDGs).	Shariah scholars have typically assessed the compliance of financial products from a structural and legal perspective – the focus is not on actual impact or real economy outcomes.

Source: Principles for Responsible Investments (PRI)

**FIGURE 2: EMBRACING COMMON PRACTICES THROUGH A SUSTAINABLE SHARIAH-BASED FRAMEWORK**



Source: Compiled by Deloitte Research and Analysis

(SDGs) and should be reflected in investment objectives, proceeds, structure sukuk issue.

These fundamental objectives have translated into contemporary social needs – that is, ‘social priority sectors’ – addressing the socioeconomic needs of the Muslim-majority economies or the economies of the Organisation of Islamic Cooperation. Recent developments in international investment show that both issuers and investors are keen and supportive of adopting the global sustainable and responsible investment (SRI) principles developed under several initiatives. One important aspect of making sukuk more attractive to these investors is to adapt these investment guidelines within its structure. While a reasonably large number of conventional bonds have adopted these sustainable and green initiatives, we have recently seen growing interest in green sukuk and sector institutions adopting these global SRI principles. This trend, in our view, can potentially accelerate sukuk issuances and broaden the investor base globally. Key to this is designing strategies within priority sectors and blending the types of SDGs and other investment practices and standards, as shown in Figure 1 on the previous page.

**RESPONSIBLE INVESTMENT AND ISLAMIC FINANCE**

The increasing discussion over the concept of responsible investment has attracted wider attention among investors globally. Clearly, Islamic finance has some resemblances as well as differences, and Table 1 lists these differences. Nevertheless, Islamic investment practitioners have debated the need for alignment between both to articulate globally accepted investment products.

However, responsible investments have been featured with three key differentiating points as follows:

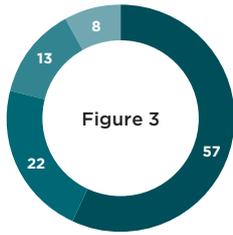
- strong emphasis on aligning finance with social good
- seek to increase the contribution of the finance sector to the real economy
- pursue a more resilient financial system void of unsustainable system risk.

**BACK TO BASICS AND THE RATIONALE FOR COMMON PRACTICES**

The trend towards common global practices for sukuk poses two types of challenge to Islamic finance:

- **Strategic governance framework:** Development of a new Shariah-based

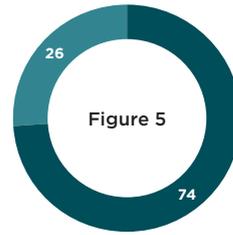
SUKUK STRUCTURES AND INVESTORS' PREFERENCE



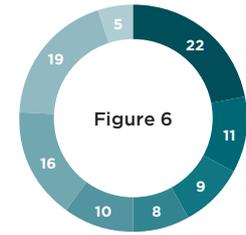
- Asset-based sukuk
- Asset-backed sukuk
- Hybrid sukuk
- Light asset sukuk



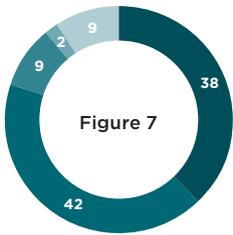
- Strongly agree
- Disagree
- Do not know
- Agree
- Strongly disagree



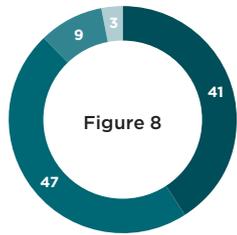
- Asset-backed structure where sukuk holders have ownership rights over the underlying assets
- Asset-based structure where sukuk holders rank side by side with unsecured creditors



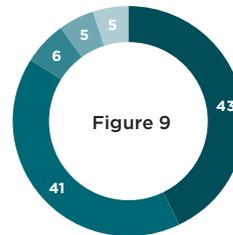
- True transfer of ownership
- Complexity and cost of structuring
- Shariah concerns
- Bankruptcy, remoteness and enforceability
- Lack of suitable underlying assets
- Legal restrictions in asset ownership
- Tax neutrality and other incentives
- Other



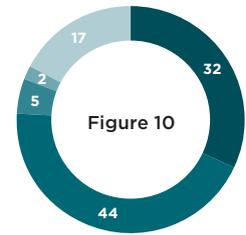
- Strongly agree
- Agree
- Disagree
- Strongly disagree
- Do not know



- Strongly agree
- Agree
- Disagree
- Strongly disagree
- Do not know



- Strongly agree
- Agree
- Disagree
- Strongly disagree
- Do not know



- Strongly agree
- Agree
- Disagree
- Strongly disagree
- Do not know

approach aimed towards improving governance practices, embedding the fundamentals of al-Shariah and aligned with global sustainable and investment principles. Figure 2 draws the lines of how these principles can be streamlined with the objectives of Shariah to design products and services, including sukuk.

- **Compliance and operational considerations:** Inconsistent legislation and reporting practices in different markets and jurisdictions pose challenges and operational risks to investors and issuers.

However, embracing a sustainable Shariah-based framework to fund projects in key priority sectors can enhance the sukuk market and increase its convergence to global capital markets. In essence, this will help boost the drive to global common practice.

**PRACTICE AND MARKET INSTITUTIONS**

In this section, we highlight some of the main views shared by participants from our online survey conducted in summer 2017. While the focus was on Shariah-related functional and operational issues, we also offered participants an opportunity to express views through an open-ended question to address other practice and investment challenges

relating to sukuk structures, investment and regulatory development.

**SUKUK STRUCTURES AND INVESTORS' PREFERENCE (SEE ABOVE)**

**Figure 3: What is the most widely used sukuk structure in your country/ jurisdiction?**

- 57% of respondents agree that the asset-based sukuk structure is widely used in their countries while 22% of the respondents view the asset-backed sukuk as the common structure.
- 13% and 8% believe that hybrid sukuk and asset-light sukuk are widely used as well.
- Recently, Saudi Aramco has used the hybrid sukuk structure for issuing a domestic offer of riyal-denominated sukuk.

**Figure 4: To what extent do you agree with the notion that the sukuk market requires more innovative structures to cater for the capital needs of corporates and lack of assets ('Ayn)?**

- Generally, the sukuk market has developed numerous structures, including perpetual sukuk and convertible sukuk.
- As markets grow, it appears there is demand for more innovation as seen

by respondents.

- 56% of respondents strongly agree that the sukuk market requires more innovation while 35% of respondents agree to the need for innovation.

**Figure 5: In your opinion, which sukuk structure is more likely to attract investors from the following two types?**

- A majority of 74% of participants believe that asset-backed structures are more attractive to investors than asset-based structures.
- This is attributed to that the fact that sukuk holders have legal ownership with the right to dispose of the assets and they have recourse to the asset in case of defaults.
- Investors always seek more security and prefer to have some form of assurance regarding ownership rights over the underlying assets.
- Nonetheless, asset-based sukuk structures are widely used despite their disadvantages over asset-backed notes.

**PRACTICE AND SHARIAH CHALLENGES**

A better understanding of Shariah compliance concerns can help improve operational and functional processes and significantly reduce risks and costs associated with that. To assess

**TABLE 2: KEY RECENT DEVELOPMENT BY STANDARD-SETTING BODIES (SSBS)**

<p>Islamic Financial Services Board (IFSB)</p>	<p><b>The IFSB launched, for consultation, an Exposure draft (ED-21): Core principles for Islamic finance regulation (Islamic capital market segment)</b></p> <p>The main objective of ED-21 is to provide a set of core principles for the regulation and supervision of the Islamic capital market (ICM), taking into consideration the specificities of Islamic finance, while complementing the existing international standards, principally the International Organization of Securities Commissions' objectives.</p>	<p><b>IFSB-19, Guiding principles on disclosure requirements for Islamic capital market products (sukuk and Islamic collective investment schemes)</b></p> <p>IFSB-19 outlines disclosure requirements for sukuk and ICIS, covering the main stages of disclosure, ie, initial, ongoing (periodic and immediate) and point-of-sale disclosure. In addition, the document provides guidance on the disclosure requirements for private offerings, government and multilateral issuances, and cross-border issuances with regard to sukuk.</p>
<p>Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)</p>	<p><b>AAOIFI's new and revised accounting standards on sukuk</b></p> <ol style="list-style-type: none"> <li>1. Exposure draft: FAS 34 - Financial reporting for sukuk holders</li> <li>2. Exposure draft: FAS 29 - sukuk issuance</li> <li>3. Exposure draft: FAS 25 - Investment in sukuk, shares and similar instruments</li> </ol>	<p><b>UAE adoption of AAOIFI standards:</b></p> <p>According to the recent pronouncement, all fully-fledged Islamic banks, Islamic windows of conventional banks, and finance companies offering Shariah-compliant products and services in the UAE are required to comply with AAOIFI standards with effect from 1 September 2018.</p>
<p>Islamic International Rating Agency (IIRA)</p>	<p><b>IIRA to operate as a licensed credit rating agency in the Sultanate of Oman</b></p> <p>The IIRA has been authorised as a credit rating agency in Oman, according to the communication by the Capital Market Authority of Sultanate of Oman with IIRA.</p>	
<p>International Islamic Financial Market (IIFM)</p>	<p><b>IIFM Standard No. 12: sukuk standardisation (to commence soon)</b></p> <p>As per IIFM, consultation process on the sukuk standardisation project will involve the development of specific guidelines and standard documentation on Ijarah sukuk.</p>	

Source: Compiled by Deloitte Research and Analysis

these issues, we designed a set of questions to obtain more clarity from industry practitioners.

**Figure 6: In your opinion, what are the key reasons that impede sukuk issuers/ investors from opting for an asset-backed sukuk structure? Please select your top three answers.**

- The survey respondents indicate that there are various reasons that might impede sukuk issuers and investors from opting for an asset-backed sukuk structure, and the most prominent reasons include a true transfer of ownership, legal restrictions and the lack of suitable underlying assets.
- 22% believe the issue of true transfer of ownership is the main reason that hinders sukuk issuers and investors from opting for an asset-backed structure, whereas 19% believe the problem stems from legal restrictions in asset ownership.

**Figure 7: The use of asset-light sukuk, in the absence of tangible assets ('Ayn), has given rise to a number of Shariah concerns such as tradeability. To what extent do you agree with this statement?**

- Tradeability of sukuk remains an unresolved issue and different

views have emerged, particularly to the fact that there is an absence of tangible assets in the case of the asset-light sukuk.

- 42% of respondents agree that the use of asset-light sukuk, in the absence of tangible assets, has given rise to a number of Shariah concerns such as tradeability.
- 2% strongly disagree with this statement and 9% disagree to some extent.

**Figure 8: In asset-based sukuk, the right of disposal of the underlying asset continues to pose serious Shariah concerns. To what extent do you agree with this statement?**

- The disposability of the underlying assets in asset-based sukuk continues to cause challenges.
- 41% strongly agree that the right of disposal of the underlying asset continues to pose serious Shariah concerns.
- 9% disagree with the above statement and do not think of the disposal of underlying assets as an issue.

**Figure 9: AAOIFI is required to provide more clarity and guidance on the repurchase of assets at maturity whether at par value, original sale**

**price, market value or fair value. To what extent do you agree with this statement?**

- Central to the sukuk investment structure is the element of repurchasing the asset at maturity and the majority of our respondents believe that more clarity and guidance are required.
- 43% strongly agree that AAOIFI is required to provide more clarity and guidance on the repurchase of assets at maturity whether at par value, original sale price, market value or fair value. However, 5% of respondents strongly disagree with the statement.

**Figure 10: The IIRA's fiduciary ratings concept is 'welcome news' to the sector and should be widely accepted as good practice to strengthen Shariah governance and investor confidence. To what extent do you agree with this statement?**

- Ratings of sukuk remain at the forefront of investment in sukuk and all credible rating agencies now have developed different analysis models for sukuk.
- A unique fiduciary rating approach was developed by the IIRA and our survey respondents have strong supportive views on this concept.
- Three-quarters of the survey's participants view the concept as good practice to strengthen Shariah governance and investor confidence. Table 2 illustrates some recent practice initiatives led by sector Standard-Setting Bodies (SSBs) to improve practices relating to sukuk investment, issuance, standardisation and compliance.

These important practice considerations, in our view, strengthen the case for global common practices in sukuk markets to enhance regulatory strategy capabilities for the larger debt and capital markets and streamline fragmented markets.

Moreover, AAOIFI has been engaging sector stakeholders in a process of reviewing its standards, which includes revised accounting standards on sukuk FAS 29: Sukuk Issuance, and FAS 34: Financial reporting for sukuk holders (EDs issued, being finalised), along with revision of FAS 25: Investment in sukuk, shares and similar instruments.

It is also worth noting that the IIRA has developed a unique approach to rate and assess risk related to sovereign sukuk, which needs to be widely communicated, improved if required, and used.

# ANALYST VERSUS MACHINE-LEARNING PREDICTIONS OF RISK

MiFID II HAS CAST GLOOM OVER THE CAREERS OF MANY INVESTMENT ANALYSTS; WILL THE MACHINES SPREAD EVEN MORE DESPONDENCY? NOT QUITE, SAYS NEW RESEARCH - YET

Professor Bill Rees and Alistair Haig ACSI – a regular face at CISI events over recent years – have been taking a close look at how investment analysts compare with their electronic friends when predicting risk. They contrasted analyst and machine-learning based forecasts of share price volatility. They found that analysts marginally outperform the machine-learning approach for a relatively homogenous US sample, but marginally underperform for a diverse international sample. Both predictions can be improved by incorporating information from the other. “While the analysts in our study are not subject to sell-side biases, we find evidence of analysts underestimating risk for stocks classified as ‘buy’; we find no equivalent biases in machine-learning predictions. Our analysis confirms the potential of artificial intelligence in financial analysis, yet analysts’ predictions of risk still compete with those based on machine learning.”

*The full paper is available (with references) at [cisi.org/analystai](http://cisi.org/analystai)*



UNIVERSITY OF EDINBURGH  
Business School

The assessment of risk is a crucial element of analysts’ work and both Liu et al. (2007) and Joos et al. (2016) demonstrate that sell-side analysts’ assessments have a clear ability to predict risk. However, over the past decade institutional, regulatory and technological changes have disrupted the market for investment research (Bradshaw et al. 2017; Groysberg and Healy, 2013; Haig and Rees, 2017). Our focus on recent evidence (2012–2017), independent analysts’ output and an international sample captures part of that institutional change and contributes to its evaluation. The accompanying technological innovation has not previously been investigated and is potentially disruptive. This paper re-evaluates the efficiency of analyst

predictions of risk in this light and explicitly compares it with predictions based on machine learning.

We use risk measures derived from data provided by Morningstar, an independent research organisation, which has supplemented its analysts’ research with a machine-learning approach (hereafter ML). This ML output includes trading recommendations, target prices and risk assessments which can be matched with equivalent predictions from Morningstar’s financial analysts. In this analysis we concentrate on risk, measured as annual share price volatility. The prior evidence suggests that financial analysts can predict risk with some success, whereas predicting trading recommendations and target prices is more problematic. In an efficient market the collective wisdom regarding the relative pricing of stocks should be difficult to beat, whereas there is no equivalent competitive element to risk assessment. For most stocks, risk in the next period is strongly associated with risk in the last one.

Thus, whether analysts or machine learning can provide forecasts that have predictive ability is not contentious: it would be surprising if they did not. We therefore use risk assessment as an achievable benchmark to compare analysts and ML. We find that data from both analyst and ML techniques can be effectively used as risk measures and both provide information beyond that contained in financial variables, including lagged volatility. Importantly, each can be improved as an indicator of risk by using information contained in the other. These results hold across time and for both the US and non-US sample.

However, the two samples present different challenges for both the analysts and ML techniques. The US sample has a relatively homogenous regulatory, accounting, legal and economic background and the sample constituents are stable across the 20 quarters of analysis. The non-US sample includes heterogeneous environments and grows throughout the period with new firms

joining each quarter. The non-US sample presents a more demanding setting for the analyst, and a case could be made that the same would apply to ML or, conversely, that the objective data analysis on which the technique is based might cope effectively with such diversity.

We find that ML assessments are almost as effective for the non-US sample as for the US, whereas analysts’ assessments are significantly less effective for the non-US sample. The decline in analysts’ predictive ability is such that the ML predictions outperform those from analysts for the non-US sample. This indicates a potential advantage beyond the obvious ability of machine-based techniques to produce more frequent and more comprehensive coverage than is feasible with analysts: for our sample, the ML approach handles unfamiliarity better than analysts.

As we use analysts from an independent research provider, the common biases exhibited by sell-side analysts are at least considerably reduced and possibly absent (Allee et al. 2017). This is most obviously demonstrated by the fair value to price assessment. For example, Joos and Piotroski (2017) report a mean fair value to price of 1.159 for their (2007–2012) sample from Morgan Stanley with only 22% below one. The mean fair value to price for our pooled sample is 1.055 with

45% below one. Yet, despite the absence of typical sell-side incentives, our tests still demonstrate mild bias.

We show that analysts’ risk assessments are relatively optimistic for companies for

// OBVIOUS ABILITY OF MACHINE-BASED TECHNIQUES TO PRODUCE MORE FREQUENT AND COMPREHENSIVE COVERAGE //

which they issue buy recommendations. We find no equivalent bias within the ML derived risk measures. Our analysis is based on interpreting the spread between analysts’ ‘consider buy’ and ‘consider sell’ price estimates, and the ML inter-quartile spread from multiple iterations of its valuation model, as valid indicators of expected share-price volatility. Neither are explicit forecasts

of volatility and any inefficiency revealed by our results could be attributed to the differing objectives of the information providers.

Even so, our results can be interpreted as an evaluation of the usefulness of analysts' and ML output in predicting risk. They suggest that both approaches work, but, if we want to improve the risk prediction, a combination of mind and machine would be superior.

## RESEARCH BACKGROUND

### Prior evidence

In the previous research Liu et al. (2007) focus on future share price volatility, while Joos et al. (2016) concentrate on absolute pricing error. Further, Liu et al. (2012) report that the publication of analysts' risk assessments impact on share prices and investment returns, and Joos and Piotroski (2017) show how the relationship between

upper and lower bounds of risk and the analysts' target price can be used to discriminate between more and less accurate investment predictions.

Hasim and Strong (2015) also find that target prices accompanied by risk

assessments outperform those without. Hasim and Strong (2015) use a wide-ranging sample of reports on US firms while Liu et al. (2012) and Joos and Piotroski (2017) concentrate on data from one brokerage firm; all use risk assessments provided by sell-side analysts, with their well-established propensity to biases (Bradshaw, 2011), and all concentrate on US firms.

The inclusion of explicit risk assessment in analysts' output is relatively recent and still growing. Hasim and Strong (2015) take a snapshot of practice in 2008 and 2009 and in analysing a useful cross-section of sell-side analyst reports they find close to one-third include bull-bear analysis (BBA). The Joos et al. (2016) and Joos and Piotroski (2017) papers also examine BBA and conveniently include an example from their data provider, Morgan Stanley. This shows that the analysts have considered and valued explicit up- and down-side scenarios.

An alternative practice is to allocate a risk description to each stock. For example, Liu et al. (2007 and 2012) use risk categories from Salomon Smith Barney, later Citigroup. Their first

sample (2007) is taken in each January and February from 1997 to 2002 and the second (2012) from various sources from 1999 to 2006. In this coverage the analysts categorise stocks as being suitable for different types of investor: conservative, average, aggressive, sophisticated/diversified and sophisticated/diversified/risk tolerant (Liu et al. 2007). Few stocks fall into the extreme categories. Overall, the picture from recent research shows a strong presence of risk analysis in analysts' output. Hasim and Strong's (2015) work would suggest that in the US, shortly after the 2008 crash, it was not uncommon but also not typical.

As for our analysis, the risk measures used in prior research are not explicit forecasts of risk. In the Morgan Stanley case, they provide a value impact of an optimistic versus a pessimistic outlook,

but there is no clear indication as to the probabilities attached to each case and these probabilities can presumably differ between firms (Joos et al. 2016).

Again, it is not

immediately apparent what these categories would say about future risk characteristics. The Morgan Stanley data has been interpreted as indicating the probability of missing the target price at the standard one-year window. The Salomon Smith Barney data has also been assessed as an indicator of expected volatility but is expressed as a classification of risk (Liu et al. 2012). These are both reasonable interpretations, which enable evaluation of the data, but the forecasts do not directly translate as outcomes.

### OUR SETTING

Our data comes from a relatively large independent provider of equity research. With around 120 analysts covering securities issued by 1,800 companies (Morningstar, 2015, 2017) its scale is comparable to a large brokerage firm (although smaller than the very largest global investment banks) but without the incentives faced by sell-side analysts (Barber et al. 2007). Analyst data is available from 2002; over time the coverage has expanded from the original US universe and includes all sectors. Each analyst

covers, on average, 15 firms and typically holds similar credentials to sell-side analysts (Kang et al. 2018). Morningstar's equity research reports and outputs resemble those of a brokerage firm.

In our dataset, we have two different indicators of risk from the same supplier (Morningstar, 2015). The first is a traditional risk classification into low, medium, high and very high (plus extreme but we have not identified any such case in our sample). This is nominally built on a bull and bear analysis with 25% probabilities assigned to the chance of exceeding each boundary, and the spread between the two can be interpreted as the interquartile range. While this indicator can be interpreted as bull and bear scenarios, it also bears the characteristics of a risk classification with 5% classified as low risk, 48% medium, 38% high and 9% very high.

The spread between bear, designated 'consider buy' and bull, 'consider sell', divided by the average of the two, is 44, 63, 88 and 111%, respectively. As with Liu et al. (2007), we treat this both as an ordered classification and also as a continuous variable and find no appreciable difference between the results. The second Morningstar variable is a measure of dispersion within the valuation model calculated as the interquartile range from 500 iterations of the model. It therefore reflects uncertainty but is not explicitly a prediction of expected risk. The mean spread measure attributable to analysts is 0.774 and to machine learning 0.146, and the mean outcome volatility is 0.252. This variation in the calculation of risk measures, as with prior work, implies that we cannot directly compare the coefficient transforming different types of predictions to outcomes of risk.

// PICTURE FROM RECENT RESEARCH SHOWS A STRONG PRESENCE OF RISK ANALYSIS IN ANALYSTS' OUTPUT //

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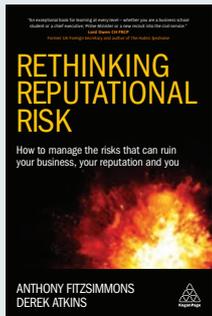
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## 'THREE LINES OF DEFENCE': A DANGEROUS DELUSION

TRADITIONAL RISK MANAGEMENT MODELS AND SYSTEMS HAVE BEEN CHALLENGED IN THE DECADE SINCE THE FINANCIAL CRISIS, SAYS LAWYER AND RISK GURU **ANTHONY FITZSIMMONS**



A 'three lines of defence' risk management model sounds reassuring, but it contains a flaw. The model was implicitly endorsed by the UK's now defunct Financial Services Authority in 2003 and is still

characterised as "sound operational risk governance" by the Basel Committee on Banking Supervision. But it failed to prevent the recent financial sector crisis.

'Three lines of defence', ubiquitous in financial services and widespread elsewhere, actually has four layers. Line managers deal with risks as they take them. Centralised teams monitor and report on risk to the CEO's team and to the board. Internal and external auditors should bring an independent view. And the whole is overseen by non-executive directors, typically the audit or risk committee.

The Parliamentary Commission on Banking Standards criticised the model, for promoting a "wholly misplaced sense of security", blurring responsibility, diluting accountability and leaving risk, compliance and internal audit staff with insufficient status to do their job properly. They thought much of the system had become a box-ticking exercise.

The Commission correctly identified a failure in implementation of the model, but the model has a deeper, more dangerous flaw, because it takes no account of the evidence on the real root causes of failures.

Most major institutional disasters lead to an inquiry. But as Anthony Hilton FCSI(Hon), the City commentator, sagely remarked: "Inquiries are rarely the answer because it is in the nature of inquiries to stop just at the point when they get interesting; in other words they stop when they have found someone to blame. Not for nothing did the late management guru Peter Drucker say that too often the first rule in any corporate disaster was to find a scapegoat. So inquiries focus on the processes within an organisation until they find some hapless

individual or group who departed from the manual."

My co-author, Professor Derek Atkins, and I have been deeply involved in two recent studies of the root causes of major crises and failures. We were two of the four authors of *Roads to Ruin*, the **Cass Business School** report for Airmic. More recently, we doubled the scale of the study, publishing our conclusions as Reputability's report *Deconstructing failure - Insights for boards*. Taken together, these seminal reports dig to the root causes of over 40 major crises and failures, spread across the financial and non-financial sectors and involving companies with collective pre-crisis assets beyond the GDP of the US. The reports bring a new, and fundamentally different, insight into why large, respected companies fail. The patterns of failure revealed show that the 'three lines of defence' model failed because of a fundamental gap in risk management.

Our breakthrough is the recognition that the root causes of almost all the crises and failures we studied emerge from normal human behaviour and the way in which humans are organised and led within firms. We call these previously unrecognised risk areas 'Behavioural' and 'Organisational' risks, collectively 'People' risks. (Andrew Bailey, then chief executive of the Bank of England's Prudential Regulation Authority, put this robustly in a speech on 9 May 2016.)

People risks lie at the root of all the failures studied for 'Deconstructing failure' both in the financial sector and outside it. But 'three lines of defence' provides no defence against people risks in general, still less against people risks within or emanating from the board, because risk management systems don't go there. Risk management hasn't yet evolved systematically to take in people risks, so few risk professionals understand them; and the most important risks are also too hot to handle because they emanate from boards.

With these insights it is no surprise that the doctrine failed to prevent the last banking crisis. Nor will it prevent the next one - or crises in other sectors.

These gaps have to be filled if boards and regulators are to be able to sleep at

night. Two developments are required. The first is to develop a cadre of risk professionals with skills in people risks, the main drivers of reputational damage and corporate collapse.

But that will not deal with the issue of vulnerabilities in or emanating from boards that regularly bring organisations to their knees. For that, a second development is essential. Boards need new tools that will both assess risks in and caused by the board; and help boards to overcome the cognitive biases that make it hard for all of us to see ourselves as others can.

In 'Deconstructing failure' we recommend a new tool to meet this need. We call it the 'Board Vulnerability Evaluation' (and we have now done the work to develop it). The tool is designed to help chairmen and their boards to:

- Systematically understand and identify potential sources of corporate vulnerability within and outside the board, including people risks and risks from inadequate information flows to and from the board.
- Analyse the potential consequences of these risks and weaknesses individually, in combination and in combination with other risks.
- Prioritise and galvanise action where needed to mitigate these risks.
- Set risk appetite.
- Gain insights as to the extent to which people risks elsewhere in the organisation need investigation.

It is a tragedy when a respected company fails, and the cost can be catastrophic. Board Vulnerability Evaluation will give boards the opportunity to find, prioritise and where appropriate deal with these unrecognised but potentially devastating risks before they cause serious harm.

**Anthony Fitzsimmons is the author, with Professor Derek Atkins, of *Rethinking reputational risk*. He spoke at a special CISI masterclass on these themes on Monday 10 December 2018.**

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## LAST WORD

# Is it time for a National Wealth Service?

**Andrew Davis**

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THE UK'S NEW SINGLE FINANCIAL GUIDANCE BODY SHOULD TAKE INSPIRATION FROM THE OBJECTIVES OF THE COUNTRY'S NATIONAL HEALTH SERVICE

“ We're all justly proud of our National Health Service (NHS) in Britain – has the time come for us to create a National Wealth Service, open to all and free at the point of delivery? The question is timely, given the official launch in January 2019 of the Single Financial Guidance Body (SFGB).

Rolling up the UK's main state-backed financial guidance bodies into a single organisation that all of us can turn to for help with money matters is an idea that has been circulating for years. Finally, with this year's Financial Guidance and Claims Act, it is becoming a reality through the merger of the Money Advice Service, the Pensions Advisory Service and Pension Wise.

“ Making a success of the SFGB could improve the lives of millions in this country who suffer ”

This is a big moment and – if done right – represents our best chance of helping millions of people overcome a major vulnerability: their lack of basic financial capability. Evidence of their struggles has been piling up for decades. The Organisation for Economic Co-operation and Development's regular PISA (Programme for International Student Assessment) studies repeatedly show that disturbingly large percentages of people across the developed world are foxed by concepts as basic as unit prices and interest rates. Reports in the UK suggest one in five of us cannot read a bank statement. When so many feel so uncertain in their everyday dealings with the vast financial services sector,

is it any wonder that they don't believe it will treat them fairly?

The solution to this pervasive problem has many strands and will take years to make a meaningful impact. However, there are several reasons for thinking that we are starting from a reasonably promising place.

### A good start

First, creating a single, national organisation (albeit with a few differences in Scotland and Wales) should make it much simpler for people to know where to turn. There are too many organisations trying to address this problem today. Many do great work but the landscape is too confusing for most people. 'Single' is the crucial word in the new organisation's unwieldy title.

Its emphasis on guidance is also a big potential plus point, although I have reservations about that term. I hear time and again in conversations about the personal finance market that most people don't want advice, which they find expensive and hard to understand. What most are after is 'help'. They want to speak to someone knowledgeable who can help them understand their choices and the issues they need to watch out for. This help needs to be delivered in plain English by people who have their best interests at heart and are not trying to sell them anything. If the new organisation could manage the same blend of expertise and empathy we see from all those medical staff on TV shows such as *24 Hours in A&E*, it would be well on the way to success.

To succeed on that scale, however, it will have to become much better known than any of its predecessor organisations. Here, again, there are helpful and encouraging precedents. The Current Account Switching Service run by Bacs has lifted public awareness from less than 60% in late

2013 to 80% in 2018 for its service, which, like the SFGB, is aimed at a very broad UK audience. Its success was partly thanks to excellent creative advertising, including 'Switch Guarantee Guy', and partly because it adopted a partnership model with the banks, who are members of Bacs, placing its branding on many of their communications and greatly amplifying its reach. The SFGB will be funded by a levy on financial services companies and needs to piggyback on their communications in the same way.

Finally, the SFGB will require explicit backing and endorsement from the government to validate it as authoritative, independent of the financial services sector and trustworthy. If it is to succeed, ministers must not just enable it – they must champion it and remain engaged in its agenda to ensure the focus is broad and ambitious enough, from developing proven financial education programmes for schoolchildren and young adults to supporting people to save, escape problem debt and manage their money through retirement.

### Be ambitious

More responsibility for our own financial well-being has been passed down to each of us over recent decades. Many are ill-equipped to shoulder those risks. Making a success of the SFGB could improve the lives of millions in this country who suffer chronic stress and insecurity due to poor financial capability and understanding, and who routinely pay over the odds for essential services. And although the National Wealth Service might be a fanciful name for this new organisation, its architects should approach their task with the same ambition that 70 years ago inspired the creation of Britain's NHS. The nation's financial well-being deserves nothing less. ●

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of you use our online member portal, MyCISI



50%

of respondents felt confident talking about stress, anxiety, or depression to their manager

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# Membership Survey 2018



of you wanted to be more involved in your local network

Contact: [crm@cisi.org](mailto:crm@cisi.org)



of respondents would support having a digital membership card rather than a plastic one

We are investigating what might be possible for next year

2,701

Total respondents

25%

increase on 2017

1,409

people gave us feedback on what you think trends will be over the next 24 months

people gave us feedback on what events you want

1,323

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