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SEPTEMBER 2014

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Contents

- 5 CITY VIEW**
The financial hardship whistleblowers can suffer must be taken into account
- 6 NEWS REVIEW**
News and views from the CISI
- 11 FIRST PERSON**
The eurozone has reached a turning point, but it is not yet out of the woods, warns *Christopher Adams*
- 12 SQUEEZING PROFITS**
Regulation is hurting profits, but the pain is greater for some firms than others, says *Chris Alkan*
- 16 CENTRAL FIGURE**
Lead player in the creation of the CREST system Iain Saville CBE FCSI(Hon) talks to *Lawrence Cohen*
- 19 RINGING THE CHANGES**
Weighing up the impact that MiFID II will have on the operations of businesses
- 22 PLAYING IT EXTRA SAFE**
What the new rules on protection of client assets mean for firms
- 24 A CAPITAL IDEA?**
Andrew Davis assesses the validity of the argument at the heart of Thomas Piketty's controversial book
- 26 CONTINUING TO EVOLVE**
The route to achieving the optimal balance for your CPD commitments
- 29 REVIEW OF FINANCIAL MARKETS**
Turn to the centre pages for the latest academic journal
- 41 CLAIRE'S MONSTER CHALLENGE**
Swimmer Claire Bennison, Chartered MCSI, takes on Loch Ness for charity
- 42 PILE OF PROBLEMS**
A junior manager is pressured by his boss to cut corners with regulation
- 44 BIG DATA AND WHY IT MATTERS**
A major new study casts some light on the practical benefits for business
- 46 LAST WORD**
Andrew Davis curses the reversal of roles which has turned us all in to amateur macro-economists



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City view



SHOULD THE UK FOLLOW THE US IN REWARDING WHISTLEBLOWERS FINANCIALLY? THE JURY IS OUT - BUT ARE THOSE OPPOSING THE MOVE IGNORING A KEY FACTOR?

Whistleblowing and its apparent public benefits are very much a topic of the moment, driven largely by sometimes huge financial rewards to whistleblowers in the US. This has led to widespread calls for similar incentives to be available in the UK, as if the seeming elixir of whistleblowing is the answer to many of our problems.

The Department for Business, Innovation and Skills (BIS) investigated the potential benefits of amending UK legislation, and the Financial Conduct Authority (FCA) looked at whether the results obtained in the US by the establishment of the US Securities and Exchange Commission Office of the Whistleblower might be replicated in the UK. These studies suggest that neither the BIS nor the FCA believe financial rewards for whistleblowers would be appropriate or beneficial in the UK and these arguments are set out in a recent FCA and Prudential Regulation Authority (PRA) paper on Financial Incentives for Whistleblowers.

Significantly, the headline-grabbing multimillion-dollar awards made in the US have, in the main, been made under the False Claims Act, dating from the US Civil War and in existence for 150 years. This act is designed to protect the US Government from being defrauded and consequently casts a very wide net. Dodd-Frank provisions are designed to protect the public and, as a result of some 6,000 reports, payments have been made

of some \$15m (mostly to one person). This contrasts with awards under False Claims and related legislation, which has seen multiples of this figure awarded on a number of occasions.

In the UK, statistics collected by the FCA suggest that of some 4,000 reports made over the past 12 months fewer than half fit the whistleblower criteria set out in the Public Interest Disclosure Act governing UK whistleblowing and fewer than 10% of these would meet the criteria for consideration of a financial award, using US guidelines. Even so, the jury may be said to still be very much out on the benefits of the introduction of UK awards.

Despite this highly public 'Non' to the proposal for financial rewards, the subject of 'speaking up' is clearly not going to go away. The CISI, as part of its mission to promote high ethical standards, is launching a new

“ Fewer than half fit the whistleblower criteria laid down in the Act ”

presentation for Corporate Supporters and members entitled 'Speak Up'. The title was chosen because it is less inflammatory than 'whistleblowing', which conveys the impression there are serious wrongs to be uncovered. As a part of the initiative, the Institute has surveyed members to gauge

enthusiasm for introducing rewards for whistleblowers. The verdict from more than 1,100 respondents was a resounding 'yes', with 81% 'strongly' or 'somewhat' in favour. This seems to send an unequivocal message.

What those who argue against 'say and pay' seem to underplay is the financial hardship so often suffered by whistleblowers, despite the apparent protection afforded them through the ability of employment tribunals to award unlimited compensation. The CISI believes that this provides inadequate reassurance to potential whistleblowers and so fails to encourage those with valuable information to put themselves in financial harm's way.

Statistics from charity Public Concern at Work show that 81% of whistleblowers in the finance industry felt that their position had worsened as a result of blowing the whistle. In this light the Institute suggests a system of financial restitution, a Financial Protection fund, established from the substantial fines levied by the regulator, and where payment is not related simply to the amount recovered, could provide the necessary reassurance to potential whistleblowers to make a difference. In the meantime, the CISI's approach is to promote a culture where observers of wrongdoing are encouraged to speak up at an early stage, before the wrongdoing becomes entrenched. To achieve this, they must be supported by their employer, the regulator and government in order to foster a culture that truly is honest, open, transparent and fair.

60-SECOND INTERVIEW

Joanne Welsh is a teacher with a difference. This month she will embark on her second year teaching young people in Liverpool about financial services in a role sponsored by the CISI Educational Trust



What does your role involve?

Based at Archbishop Beck Catholic College in Liverpool, I teach the CISI Level 3 Certificate in Finance, Risk & Decision Making to students aged 16-19.

This is the first certificate of the CISI Level 3 Diploma in Finance, Risk & Investment, which is equivalent to a full A-level.

How does it differ from conventional academic subjects?

Firstly, this course is not delivered in a school setting but in a number of different establishments – in the last academic year, Deutsche Bank, Investec, Pershing, Quilter Cheviot and Rathbones. Students gain an insight into the knowledge required to be successful within the industry and can visualise what it would be like to be employed within the sector, resulting in raised aspirations.

Furthermore, industry experts contribute to the delivery of sessions, helping students to discover how the knowledge they are acquiring is useful in practice.

The nature of the subject is diverse. I can best describe the qualification as a mixture of business studies, economics, and accounting and finance. Consequently, it is unique and cannot be compared to any one subject within the college curriculum.

I am delighted that continued support will be provided by firms for the 2014/15 intake.

What is the verdict so far of students and yourself on the programme?

The programme is challenging, rewarding and allows the broadening of knowledge, and that is just my own personal gain! In the last academic year, 14 students from six local schools took the course and, most importantly, have enjoyed this educational journey. They showed great commitment and engagement; every individual wants to participate in work experience within the industry in the near future.

CISI qualifications are vocational. Are students increasingly looking at alternatives to university after leaving school?

Yes. Is it because of the rising costs of going to university or as a result of students becoming more aware of the benefits that arise from entering the world of work earlier? From my own experience, it is the latter. Young people want to gain valuable work experience in a supportive setting and kick-start their career.

Apprenticeships in the financial investment management sector are in high demand which therefore results in a strong field of candidates. In my role as Advanced Apprenticeship Co-ordinator at Archbishop Beck, it is not unusual to receive 150+ applications for one apprentice post.

- For further information about the CISI's education programme in schools and colleges and how you can lend your support, visit cisi.org/education or email educationdevelopment@cisi.org

Restaurant review: Novikov Restaurant & Bar, London

By Patricia Robertson, Chartered FCSI, Director, Westport Global, London



Novikov has a real feel of the Far East: open, clean, with simple wooden seats giving it a hint of tropical alfresco eating. There is a good variety of table sizes, and tables are close while still allowing for privacy when discussing business.

The freshness of the ingredients is central to the restaurant's concept. The food is Asian-based:

Japanese, Chinese, Korean to name a few countries. From the large choice of dishes we settled for dim sum, including shiitake dumplings (vegetarian), prawn curry dumplings and duck rolls. The dumplings were light and popped in the mouth with glee in the knowledge they would be easily digested.

The restaurant has a full range of Italian-style coffees – always good to have before heading for the office.

Would I go there again? Yes, I am reaching for the diary and wondering which client needs a meeting during lunch as I write!

FOOD: 4/5
SERVICE: 4/5
ATMOSPHERE: 4/5

- Fancy writing a restaurant review? We will publish the best online and in the print *S&I*R, and the final winner will receive a foodie prize. Please send your reviews to richard.mitchell@cisi.org



Novikov Restaurant & Bar, 50A Berkeley Street, Mayfair, London, W1J 8HAT, +44 20 7399 4330, reservations@novikovrestaurant.co.uk

Ask the experts: Peer-to-peer lending

How does peer-to-peer (P2P) lending work?

P2P lending means lending money directly to individuals, or 'peers', without going through a traditional financial intermediary such as a bank. P2P lending companies match individual lenders and borrowers online.

We believe the process to be efficient and fair, with lenders getting interest back from the borrowers, while the P2P platform takes a small fee. Each P2P company operates slightly differently. Zopa seeks to limit the risks through diversification by lending one person's money to lots of people rather than to a single borrower.

We have a very strict credit-checking process resulting in the rejection of about 80% of applications from borrowers. We have a Safeguard fund of almost £5m, which pays back the lender the outstanding capital plus interest in the event of the borrower defaulting, but it is not a guarantee. Lenders, meanwhile, must not be lending in the course of any business, unless they are doing so under a current consumer credit licence. There is no maximum lending limit: we have one customer lending about £1.6m, although the average is £5,500, and lenders can start with just £10.

P2P platforms tend to serve different areas of the market. Funding Circle, for instance, lends money only to businesses, while other platforms lend only for property investments, such as buy to let.

P2P lending is on track to hit a record £1bn in 2014. Why do you think this type of lending is proving so popular?

Many consumers feel that by cutting out banks, P2P lending gives them greater control and provides them with a more transparent way of managing their money. In essence, it is old-fashioned banking: borrowing money from people and then lending it to others. P2P lending also provides an opportunity to generate attractive returns, which is particularly appealing in the current low-rate environment.

The 2008 banking crisis had an impact, with the banking system being seen by many as toxic. Customers' trust in banks was damaged, resulting in people looking for what they see as more honest and ethical ways of growing and borrowing their money.

P2P lenders often say they derive satisfaction from being able to lend to 'real people'. Someone setting up a P2P platform account with Zopa can go online and see the borrower's username (not their real name), along with details such as their age and, often, the reason they are borrowing the money. Meanwhile borrowers can gain an insight into who has lent them the money.

With P2P lending rising, what are the authorities doing to regulate the industry and maximise its growth potential?

P2P lenders have been regulated by the FCA since 1 April this year – a development the sector lobbied for, believing it to be a stamp of approval. P2P lending received a further boost in this year's Budget, when the Government announced people would be able to hold P2P loans within an ISA, making these loans even more appealing to consumers due to the tax benefits ISAs offer. As we are now regulated by the FCA and with news around ISAs, IFAs are increasingly inquiring about investing client money through us.

Inclusion in ISAs will help to further distinguish P2P lending from crowdfunding, which involves funding a project or venture by attracting contributions from a large number of people, typically via the internet. Crowdfunding and P2P lending are regulated under the same mandate, but operate very differently in some respects. Crowdfunding, for example, entails investing in a business for equity or a product; the investor is not getting a monthly annualised return on their money.

Despite the differences, crowdfunding and P2P platforms are proving to be popular alternatives to more traditional forms of banking in the UK. It seems unlikely that P2P lending will be going away any time soon.

- Check out the *Review* online at cisi.org/sireview to read our feature about the emergence of new business models.



Jonathan Kramer, Sales Director, Zopa, a peer-to-peer lending company

Keep up to date through our digital edition

Have you checked out the digital edition of the *Securities & Investment Review*?

The tablet and smartphone-friendly online issue is updated each week. It provides exclusive access for members to features, opinions and analysis on hot industry topics, over and above what is in the quarterly *Review*.

Latest highlights include an article which reviews 'green' investment initiatives, while coming soon is a feature that examines new FCA guidance for

firms wanting to provide lower-cost simplified advice. There is also an archive of articles from past print issues of the *S&IR*.

Taken together, the digital edition and the quarterly *Review* will help members to keep up to date with the latest developments and talking points in financial services.

- View the digital edition and leave your comments on featured articles, or the issue as a whole, at cisi.org/sireview



The knowledge

Exam study tips

Robin Ellis ACSI, Assistant Investment Manager at Smith & Williamson in London, was a double winner at this year's CISI Annual Awards. Now taking the final unit of the Chartered Wealth Manager qualification, Robin gives some advice to fellow exam candidates.

1 Study the material: Although this is obvious, the importance of going through the course book thoroughly cannot be overstated. It can be dull at times, but the exams are so broad, and questions can touch on some of the smallest parts of the syllabus.

2 Keep up to date: The exams tend to have a few questions inspired by recent developments in regulation or in the market. Keeping up to date with all of this news should give you an advantage on the day.

3 Practise: Do as many past papers as you can. These are available on the website along with the Chief Examiner reports. Some of the exams are quite short time-wise, so good exam technique can be just as important as depth of knowledge.

4 Test yourself: As the course is so broad, the best tip I can give would be to write out your own questions. In doing this, you will quickly identify what sort of topics are likely to come up. It is also an excellent way of assessing what you know and what you don't.

5 Relax and keep calm: The key is not to panic. If you have put the work in, you will be much better off trying to stay calm before the exam, rather than trying to fit in any last-second cramming!

• Candidates preparing for CISI computer-based exams have the benefit of access to a range of products to assist them as they study, including workbooks and the revision tool, Revision Express Interactive. These have been supplemented by exam-standard sample papers for the exams that have the highest candidature. The papers are made up of questions previously available in the live exams. Read more about Robin's exam success at cisi.org/sireview. For further information see cisi.org/study



Anish Kapoor's Turning the World Upside Down III is one of the sculptures on display at Deutsche Bank's London office

Art in the City

There are some dazzling corporate artworks in the City and beyond. In this issue we look at the Deutsche Bank Collection

Deutsche Bank might be better known for balance sheets than brush strokes, but for more than 30 years, the bank has encouraged and supported new artistic talent. The Deutsche Bank Collection, which started in the late 1970s, is today one of the world's most comprehensive corporate art collections, with artworks on display at its offices worldwide.

At the firm's London office, there are around 100 conference rooms named after artists from around the globe, from Sweden's Mamma Andersson to Japan's Miwa Yanagi. In each room a wall plaque provides a short biography of the artist alongside their work. Pictures are also on display on

all floors and along corridors, ensuring art is a continuous part of everyone's thought process.

The reception area features large artworks by Keith Tyson and Damien Hirst as well as major sculptures, including Anish Kapoor's *Turning the World Upside Down III*, described as "a great beached scientific model of the void and the world".

Deutsche Bank's new Birmingham building features two site-specific artworks by Raqs Media Collective and Idris Khan. It also houses artwork by young local artists.

• Do you have a favourite piece of art in the City to tell us about? Email richard.mitchell@cisi.org

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Calling all members

CISI members can enjoy special offers on mobile phones, including the latest 4G handsets, with EE that are not available online or on the high street.

This new deal, offered through the CISI Select Benefits package, comes courtesy of Voice Mobile, a Principal Partner of EE.

As an example, a Samsung Galaxy S5 with EE, including unlimited minutes/unlimited texts and 4GB of data on superfast 4G, is available for just £37.99 per month (including a free handset)*.

For further information, visit CISI Select Benefits via cisi.org/mycisi or call 0800 1830 991 and quote **CISI**.

*Terms and conditions apply. See website for details. Offers and prices subject to change without notice. CISI Select Benefits is managed on behalf of the CISI by Parliament Hill Ltd.



CISI AGM

The Annual General Meeting of the Institute will be held at the CISI, 8 Eastcheap, London, EC3M 1AE on Thursday 25 September 2014, at 10.30am.

Fellows (FCSI) and Members (MCSI) of the Institute may vote on the resolutions by:

- voting online using the link in the members' section of the Institute's website at cisi.org;
- using Form A to appoint the Chairman as your proxy;
- using Form B to appoint a proxy, who need not be a member, to attend the meeting and vote on your behalf;
- attending the AGM and voting yourself.

Voting forms, whether completed online or sent by post, must be received by the Company Secretary not later than 11am on Tuesday 23 September 2014.



Annual report

CISI members can access the Institute's 2013/14 Report and Accounts online at cisi.org/reportandaccounts

- If you would like a hard copy, please contact marketing@cisi.org



The *S&IR's* quick quiz features questions from CISI Professional Refresher, an online learning tool. This popular product consists of more than 55 modules covering topics including anti-money laundering and banking standards. Answers are on page 11.

1. Which are the key areas of the UK Corporate Governance Code?

- A Leadership, effectiveness, remuneration and the audit committee
- B Relations with shareholders, effectiveness, accountability, remuneration and leadership
- C Human resources, finance, remuneration and leadership
- D Chief risk officer, accountability and leadership

2. Which statement best describes the merits of investing in hedge funds?

- A They offer higher correlation to equity and bond markets
- B They offer higher correlation to index-linked gilts
- C They offer lower correlation to cash
- D They offer lower correlation to equity and bond markets

3. How frequently does a money laundering reporting officer have to make a report to the firm's board?

- A At least daily
- B At least weekly
- C At least monthly
- D At least annually

4. The powers given to the Parliamentary Commission on Banking Standards enabled it to do which of the following?

- A Make reports to both Houses of Parliament about banking standards
- B Carry out analysis of banking capital in Europe
- C Second staff and specialists from the regulators
- D Legislate on future banking standards

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 or contact the CISI on +44 20 7645 0777.

BACK STORY

Dr Joe Appiah-Kusi, Chartered FCSI, Business Analyst and Founder of London City Accountants



What started as a research project on emerging stock markets turned into something far bigger for Joe Appiah-Kusi.

During the early 1990s, African heads of state with ambitions to establish their own stock markets would visit the London Stock Exchange (LSE) for advice on how to build an exchange. Joe, being the only African employee there at that time, was

“We would have all the information we needed about their country”

requested to “pop down” to the library on a fact-finding mission on the economy and stock market any time a head of state from the continent visited.

As the frequency of the visits increased, the LSE’s

directors felt they needed a better understanding of African nations’ economies and exchanges. This saw Joe undertake a PhD on the relevant countries. His study led to a book in 1997, the *Investor’s Guide to the African Stock Markets*, which helped to open up a continent that was “the last frontier for investors”.

“It could take a broker’s secretary half a day to visit a library and find, for example, information about Ghana’s GDP, but my research had ten years’ statistics on the 15 African countries that had stock markets at that time,” says Joe. “Whenever an African head of state came to the LSE, we would have all the information we needed about their country.” His work has paved the way for many investors to back ventures and trade shares in Africa.

The project was a labour of love for Joe, who came to the UK from Ghana, his homeland, in 1979 to study for the Association of Chartered Certified Accountants’ benchmark qualification. Once qualified, he joined asset management firm Vickers Da Costa to “work in the City... and because I was interested in the stock market”. Joe then spent three years at Pershing, before joining the LSE’s settlement services division in 1991.

His career since leaving the LSE has seen him work as a project manager and business analyst for companies such as Citigroup, Bank of New York, and Northern Trust, where he worked for Belinda Jackson, Vice President of the bank. Joe is now working as a wrap business analyst, as part of a team that is building a wrap platform for a self-invested personal pensions provider.

• Want to read the extended version of Joe’s ‘Back story’? Go to cisi.org/sireview. If you would like to tell us your own back story, email janice.warman@wardour.co.uk

Events preview

The CISI runs a varied programme of events, both to support the continuing professional development of members and to provide networking opportunities.

24 SEPTEMBER CISI ANNUAL INTEGRITY DEBATE

Plaisterers’ Hall, One London Wall, London EC2



A panel of industry experts will debate: “Do UK savers and investors get a fair deal?” Panel members include Will Hutton, author, and Martin Waller, writer of the ‘Tempus’ column in *The Times* vs Dr Tim May MCSI, Chief Executive, Wealth Management Association and The Rt Hon John Redwood MCSI MP.

9 OCTOBER TRAINING & COMPETENCE CONFERENCE: UPHOLDING PROFESSIONAL STANDARDS

America Square Conference Centre,
1 America Square, Crosswall, London EC3



The conference will address challenges in implementing the Banking Standards and other hot topics, with a line-up of expert speakers and stimulating workshops.

OTHER AUTUMN HIGHLIGHTS:

- 16 September: Mobile devices in enterprise: understanding the risk (London)
- 23 September: Guernsey Investment Briefing: Investing in times of low, but increasing, interest rates
- Annual branch dinners (2 October, West Country, and Manchester & District; 9 October, East Anglia; 24 October, Isle of Man; 21 November, South Coast; 27 November, London)
- 8 October: European institutional investors and securities class actions (London)
- 9 October and 2 December: The Market Abuse Directive and Fourth Money Laundering Directive (London)
- 15 October: Leadership and integrity – the key ingredients of successful culture change? (London)
- 21 October: An Update from the Bank of England (Birmingham)
- 20 November: A conversation with Martin Wheatley, Chief Executive, FCA – with the Corporate Finance Professional Forum (London)

• For details of conferences, training courses, CPD and social events available to members, visit cisi.org/events or call +44 20 7645 0777.

Keeping Europe on the right path

AFTER YEARS OF DECLINING, EMPLOYMENT IN SPAIN IS ON THE RISE, MARKING A TURNING POINT FOR THE EUROZONE, BUT MORE NEEDS TO BE DONE

◆ CHRISTOPHER ADAMS □ JOHANNA WARD

Something extraordinary happened in Europe this summer – and barely anyone noticed. For the first time in six years, Spain's economy, one of the hardest hit by the eurozone debt crisis, recorded an annual rise in jobs.

No big deal, you might think. But such has been the despair about Europe's prospects after years of economic and market turmoil that this rebound on the continent's periphery, albeit tentative, marks a turning point. Mariano Rajoy, Spain's Prime Minister, called the creation of more than 190,000 jobs over 12 months, and a fall in unemployment from 26% in the first quarter to 24.5% in the second quarter, "a 180-degree turn" for the labour market.

This needs putting in perspective. The decline still leaves Spain with one of the highest rates of joblessness in the western world. But what makes the fall striking is that the size of the labour force increased at the same time. In other words, even with more people available for work, unemployment still fell. That is encouraging. It points to a sustainable recovery.

Across the rest of the eurozone, there are signs that activity is picking up. A purchasing managers' survey for July allayed fears that the single-currency area as a whole could stutter to a halt. There was a marked improvement in German manufacturing and services, though France suffered a third month of contraction.

None of this will be of any comfort to the millions who lost their jobs in the crisis, or who are stuck in low-paid work. Still, the growth in jobs in a country such as Spain shows there is a light at the end of the eurozone tunnel. With the risk of a break-up now negligible, the question is not whether Europe will emerge from its crisis, but how soon that will happen.

On this, opinion is sharply divided. Much will rest not just on the strength of recovery elsewhere, and especially in the US, but on the efforts of the European Central Bank (ECB) to head off deflationary forces which, if they prevail, could keep the eurozone in a period of Japan-style stagnation

from which it would take a decade or more to emerge. The ECB is taking action on several fronts to prevent this. Its most radical step, taken in June, was to cut interest rates below zero on the money commercial banks deposit with the ECB. The aim here is to discourage these banks from keeping cash 'under the bed' and encourage them to lend it out instead.

The central bank is also launching a more targeted version of its so-called 'longer-term refinancing operations', under which banks will be able to access ultra-cheap loans as long as they use the money to lend to small businesses.

Such action is important. But there has been little market reaction. The euro, which has stayed stubbornly high versus the dollar throughout the crisis, barely budged on the news. It remains relatively elevated, a frustration for the ECB because a fall in the euro would help exporters and ease the deflationary forces weighing on recovery.

More action will be needed. And that means full-blown quantitative easing (QE). Mario Draghi, ECB President, will have to go

through with his promise to do "whatever it takes" to save the euro and start buying peripheral government bonds.

He has hinted this could happen. But markets have grown used to his verbal campaign and have long been betting QE will come. The problem now is that if it doesn't and Europe's tentative recovery fails to take off, then the wall of money that has poured into the debt of Spain, Italy, Portugal and other hard-hit countries in anticipation of QE could be pulled out. That would push up their governments' borrowing costs, making it harder to cut crippling high levels of debt. Draghi needs to act soon.

Christopher Adams is the Financial Times' Markets Editor

“Much will rest on the efforts of the ECB to head off deflationary forces”



Squeezing profits

THE BURGEONING COST OF COMPLIANCE IS WEIGHING HEAVILY ON THE FINANCIAL SERVICES INDUSTRY, BUT SOME COMPANIES ARE HURTING MORE THAN OTHERS

◆ CHRIS ALKAN ➤ DALE EDWIN MURRAY

There has never been a better time to be a compliance officer. These once-humble employees are now in high demand as financial reforms impose ever-greater bureaucratic burdens. Only last year, JPMorgan Chase said it planned to spend \$4bn and commit 5,000 extra employees to upgrading its compliance and risk management. London-based HSBC added 1,800 compliance staff in 2013.

This may be great news for compliance professionals, but it is an unwelcome drain on the profits of banks, wealth management firms and hedge funds. “The growing volume of regulation has had a profound effect on operations,” says Karen Petrou, Managing Partner at Federal Financial Analytics, which advises firms on regulatory and political risks. “Most aspects of oversight have been tightened around the globe. While this has many potential benefits, it is an expensive irritation for companies and the chief executives that run them.”

It is difficult to pinpoint the exact cost of the flurry of new rules imposed since the 2008 financial crisis. That said, a survey of 800 compliance professionals around the world by Thomson Reuters in 2013 concluded that the industry was facing “the ultimate juggling act for compliance functions which were already under strain”. Two-thirds of officers said they expected the budget for their team to rise over the next 12 months. Just 1% believed spending would fall significantly.

“Competition for the most skilled professionals will remain strong,” the survey concluded.

BURDENSOME CHANGES

Compliance comes with a hefty price tag. A 2012 study by JWG, a regulatory think-tank, predicted that the industry was on track to spend €33bn up to 2015 to comply with new regulatory demands. Among the most burdensome changes, JWG calculated, is the requirement that banks report more frequently and in greater detail on areas of large exposure, on counterparty risk and on collateral. Banks are also wrestling with stricter stress tests – that measure a bank’s

“The UK has gone from a very light-touch system to a more hard-wired one”

ability to withstand a crisis – and the requirement to compile ‘living wills’, which detail how institutions can be broken up easily if they become insolvent. “Regulators are asking for data in ways they want to look at it, not in the way banks are organised to provide it,” PJ Di Giammarino, JWG’s Chief Executive, told the *Financial Times*.

Regulators, have over recent years, also been insisting on far higher standards to prevent financial crime. “Additional requirements to know customers – with a view to avoiding money laundering – have become a significant burden,” says Andrew Gray,



Partner at PricewaterhouseCoopers. “There has to be a much more rigorous process in place before engaging with another business. It is not just applying the rules, but also demonstrating and recording that you have adhered to them.”

Rigorous new deadlines for compliance and reporting are forcing companies to upgrade older IT systems. About half of the companies surveyed by JWG said their regulatory and reporting departments were understaffed.



Such pressures come at a time when other limitations on profits – including new capital and liquidity rules – have been putting profits under strain. In July, for example, Barclays reported that profit at its investment bank had fallen 50% – despite about 2,500 jobs being cut in that division.

PROFITS UNDER STRAIN

“For large banks the extra regulation and reporting requirements are not going to make or break the business,” says Petrou. “That said, the timing is bad since they

are coming into force when other rules are curbing profits.”

A report published in July by Federal Financial Analytics calculated that extra capital requirements, higher deposit protection fees and supervisory assessments cost America’s six largest banks \$70bn in 2013 – twice as much as in 2007.

“These extra burdens are also apparent in the UK,” she adds.

“Banks are hiring a lot of staff to deal with

regulation and firing a lot of people who were dealing with customers and bringing in new money,” says Alex Pollock, a researcher at the American Enterprise Institute and the former chief executive of a Chicago-based bank.

In terms of increased bureaucracy, Petrou believes that British banks have suffered a bigger shock than even American counterparts. “The UK has gone from a very light-touch system to a more hard-wired one,” she observes. ➤

“Previously, auditors were responsible for ensuring compliance was up to scratch and now the supervisors enter the banks themselves,” she observes. “That is far more demanding and time consuming.”

Nor have the wealth managers been exempt from such pressures. A survey of 30 British wealth management firms by research agency ComPeer estimated that the cost of regulatory compliance was £420m in 2012, rising to £500m by 2015.

“There are far more requirements on how wealth managers communicate with clients, ensuring that they are totally transparent and upfront,” says Nikolai Lysiuk, a senior research analyst who worked on the research at ComPeer.

“Wealth managers have so far been able to trim other expenses to keep returns high”

“So-called suitability requirements insist that firms make sure they give advice to clients that will match their risk appetite.” That involves collecting a mountain of data. “Of course, for many wealth managers this was something that they were already doing,” he points out. “For others, however, it involves beefing up back-office staff and building new IT systems.”

BURDEN IS SPREAD

The cost of employing compliance officers rose by 12% between 2007 and 2011, the study showed. There are indirect costs, including the time that employees in other departments now have to spend

focusing on compliance. Then there were additional fees levied by the new Financial Conduct Authority (FCA) and the Prudential Regulation Authority, which replaced the unified FSA.

Britain’s National Audit Office estimated that the combined cost of the two new bodies – paid for by the financial services industry – would be 24% greater than that of its predecessor, at around £664m in its first fiscal year.

Of course, this burden is spread over the financial services sector as a whole. Lysiuk points out that the wealth management industry has largely been able to weather the extra costs of compliance. “While costs seem to be heading for around £500m over the coming years, in 2013 that was only about 5% of the total costs,” he says. “The professionals who speak to clients and bring in new customers still account for about 44% of the budget.” In addition, the industry brought in a record £5.4bn in revenue in 2013 and earned a healthy 26% profit margin. “Wealth managers have so far been able to trim other expenses to keep returns high,” says Lysiuk.

LESS EXPENSIVE

The hedge fund sector has also been affected, though once again the additional costs do not appear crippling, according to a 2013 study by KPMG. Since about 32% of the world’s hedge funds are based in the UK – second only to the US – this is an important issue for London.

Traditionally, hedge funds have been among the least regulated part of the financial services industry, partly because their clients are wealthy and sophisticated individuals or financial institutions. “Many say that the ongoing cost of complying with new regulations will continue to require precious resources and time, making the industry less competitive and less appealing to investors,” the KPMG report concluded.

The industry, KPMG said, was now spending an average of 7% of its operating costs on compliance technology, headcount and strategy – a total of around \$3bn. That can amount to about \$14m for larger firms and \$6m for a medium-sized fund. So far, the bulk of these costs is being shouldered by the managers themselves, rather than being passed onto clients in the form of extra fees.

Of course, focusing merely on the burden of regulation is unfair. “We need to keep in mind that there is a purpose to this red tape,” says Petrou. “It is intended to make the system safer and fairer.” But there is no denying that, especially for banks, it is an additional squeeze on profitability.

Further information

See ‘City View: What does it take to work in compliance?’ at cisi.org/sireview



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Central figure

When it comes to central banking, Iain Saville is something of a pioneer. During a long and distinguished career as a finance professional, Saville spent more than 20 years at the Bank of England (BoE), where he managed \$40bn of foreign currency reserves in bond and money market cash and derivatives instruments worldwide.

Following the abandonment of Taurus, the Transfer and Automated Registration of Uncertified Stock project designed to transfer London Stock Exchange (LSE) settlement from paper communication to an automated system in 1993, Saville led the creation of CREST, one of the world's largest and most sophisticated securities settlement systems. Saville and his team designed, built and implemented the UK's Central Securities Depository (CSD) securities settlement system, which was launched on time and within budget in 1996.

Saville recalls: "The collapse of Taurus gave the Bank of England the opportunity to say to the market: 'Well, you tried to computerise history, it failed, so let's do it a modern way.' It wasn't an easy conversation, but building the system was relatively straightforward, and once customers got used to the new approach they decided it was efficient and easy to use."

To help introduce CREST, the LSE brought in rolling settlement. "In those days, people traded for a fortnight or so and the results of all those trades were settled on one day, which was bonkers," says Saville. "Moving from account settlement to rolling settlement was a big cultural change that required everyone to tighten up their processes, and CREST built on that."

After delivering CREST, he ran the system as Chief Executive until its sale to Euroclear six years later. Saville's work in establishing the UK's CSD led to him being awarded a CBE in 1999.

HONOURABLE DESCENDANT

Fifteen years on, Saville's achievements seem more significant and relevant than ever. He sees the European System of Central Banks (ESCB) initiative called Target2Securities (T2S) as an "honourable descendant" of CREST. "It has the same 'one-size-fits-all' goals and many of the same characteristics. Its infrastructure is designed to promote competition and it has the same flexibilities as CREST, which is important, because both features allow people to innovate.

"I think the European Central Bank (ECB) was encouraged by CREST to believe that you can foster radical change and say to the

"The main benefit of T+2 will be to encourage end users of markets to have slicker processes"

market users, this is a better way to do things and you can make this important step to a single market happen."

Saville was a key mover behind T2S, having spent five years as adviser and consultant to the ECB between 2007 and 2012, which included being a T2S Programme Board member and chairing the Bank's technical committee.

Today, he is putting his vast amount of expertise in post-trade processing to use as an Independent Director of BNY Mellon's new European CSD, helping it to capitalise

on opportunities in the securities settlement world that T2S will create. He is also an Independent Non-Executive Director of EuroCCP, now operating from Amsterdam after the merger with EMCF.

The ESCB views T2S, to be launched in 2015, as a key driver for the harmonisation of post-trade services and standards, which will contribute to achieving stronger financial integration and a true European single market. The ESCB anticipates that T2S will bring down cross-border settlement fees by fully exploiting the economies of scale resulting from the use of a single IT settlement platform, a single set of standards and a single operational framework. By enabling CSDs and banks to rationalise their internal processing and systems, moreover, the ESCB expects T2S to lead to a more general reduction of the total costs for settlement.

One of the major benefits of T2S will be that all securities balances will be held on the same computer, adds Saville. "Say you're a customer of a bank holding your securities in Italy, in T2S, it is now straightforward for Monte Titoli [the Italian CSD] to transfer them to someone in Germany or Slovakia. The account happens to be under the management of the Slovakian CSD, but it's just another account in T2S. This is so much simpler than the old approach, through which securities had to be transferred from one CSD to another."

Saville is saddened, however, that Britain will not be a part of T2S, although he understands why. "The fundamental reason is the sovereignty of our currency," he says. "The issue of who has control over the use of central bank money is much easier to solve within a single currency. Are we in or are we



“I do wonder if there isn't a very large inverted pyramid of compliance with just a few producers at the bottom”

out of Europe? Until that's resolved, I think it is hard to make a political commitment to losing some currency sovereignty in order to make the sterling securities markets fully interoperable with the eurozone markets. The optics of it are difficult, even if the practicalities might be manageable.”

As of 6 October this year, UK and Irish exchanges will shorten their settlement periods from three days to two. At the same time, securities that settle via the Euroclear system in Belgium, France and Holland will also adopt T+2.

“I think the main benefits of T+2 will be that it encourages end users of markets to have slicker processes and be faster in issuing instructions. In particular it means more computerised processes with tighter management, which typically takes costs out of the system.”

Despite endorsing both T+2 and T2S, Saville expresses concern that in the aftermath of the 2008 economic crisis, moves to regulate Europe's financial markets might have gone too far. “In the businesses in which I operate, an enormous amount of effort goes into compliance, and I do sometimes wonder if there isn't a very large inverted pyramid of compliance – legal, regulatory, financial, tax, and so on – with just a few producers at the bottom. It feels dangerously unstable because there's so much of it.”

RISKY BUSINESS

Regulators now require financial services firms to take a much more scenario-based approach to assessing risk, promoting many firms to broaden their risk outlook by bringing their client base and dedicated risk experts into their risk committees.

Saville currently chairs risk committees for both BNY Mellon CSD and EuroCCP. Although having a broad range of participants on its risk committee is nothing new to EuroCCP, the appointment of Saville to head up the committee reflects the different approach that CCPs are taking towards involving a range of users in risk management, in accordance with European Market Infrastructure Regulation (EMIR), which has been designed to increase the stability of over-the-counter (OTC) derivative markets in the EU.

Saville gives the example of Euro CCP contemplating extending its activities in OTC trades, with its risk committee analysing the risk involved in such a move. “We consider difficult scenarios and





take the advice of our client risk experts into account when deciding whether to go ahead with the activities,” he says.

As chairman of a risk committee, Saville encourages committee members to stick their necks out and say what they think. “I think my job as Chairman is to make sure they don’t agree with each other too much.”

Saville’s career could easily have gone in a different direction. He holds a doctorate in Solid State Physics from University of Oxford’s Magdalen College, along with an honours degree in Theoretical and Mathematical Physics from the University of St Andrews, but decided after his studies that a career in science was not for him.

“I was bit fed up with it at the end, and I realised that by the standards of my Oxford colleagues, I wasn’t that good at it. After graduating I probably went to a hundred first interviews to educate myself and in the end I joined the Bank of England. The Bank was at the heart of things and looked like a pretty good place to work.”

Saville later wrote a book on monetary policy with the former Economics Director of the Bank of England, “the very brilliant Christopher Dow”. “The book had a strong Keynesian flavour at a time when monetarism was flavour of the month, but it wasn’t published until after Margaret Thatcher resigned. The delay may or may not have been coincidental, but Christopher was much more sensitive to upsetting people than I was.

“After 18 months working on the book, the Bank of England asked me: ‘Why don’t you come back and run the UK reserves?’ I thought, ah, that sounds like a real job!”

The first task was to work on completing the modernisation of asset management by setting up benchmarks, allocating return to risk categories and establishing coherent risk governance.

In the late 1990s, a new challenge came along when the government pegged sterling to the future European currency with the intention of joining it. “There was a synthetic currency at the time, the ECU [European Currency Unit, a basket of currencies of the EU member states], and we issued quite a lot of ECU debt, hedged it out on the asset side and so on. In all, we made a fair amount of money for the public purse while developing the London ECU market.”

The Bank made good progress towards developing and harmonising the market, as

well as establishing the UK’s reputation as the leading issuer of ECU instruments. “Then, of course, ‘Black Wednesday’ came along, at which point we were not particularly credible as a future member of the future currency. And producing liquidity to defend sterling – the prime purpose of the reserves – was a very thorough roadtest of our new approach; I was relieved to find it worked extremely well.”

With the collapse of Taurus, the BoE was looking for someone with Saville’s skills to develop an alternative settlement system. “I volunteered: I thought, I’ve got the IT background, I’m not frightened of people in the markets and I’ve got a lot of contacts, so let’s do it. And the Bank couldn’t find anyone else to do it, so I got the job.”

When CRESTCo’s shareholders decided to sell the system to Euroclear in 2002, Saville felt it was time to move on. After spending two years as Executive Director, EMEA of Computershare, he became Head of Market Reform at Lloyd’s of London in 2004, where he spent three years helping to modernise the insurance service providers’ marketplace.

BACK TO SCHOOL

While at Lloyd’s, Saville became a governor at an East London primary school. “I was at the right stage of my life to do something like this,” he says. Despite the challenges of being in one of the poorer parts of the capital – 55% of its pupils receive free school meals and until recently, most of its classrooms were in portable buildings – the school’s performance has been transformed in the eight years that Saville has been a governor.

Singing is another of Saville’s passions. “I was in the school choir, but then I didn’t do any proper singing until I was about 35, when my wife joined a light opera society. It was recommended to her to bring me along because they were short of blokes, so I did that for a few years.”

Saville now sings in the Dulwich Choral Society. “I am the choir’s Chairman, because that seems to be my role in life these days!” he jokes. Having spent much of his career in positions of huge responsibility, he welcomes being part of the chorus line. “There’s something very nice about being a back-row tenor or bass and thinking that it’s someone else who’s waving the stick at the front.”

Saville remains firmly at the forefront of things, however, in his working life, helping firms get the most out of a Europe-wide securities settlement system that he has played no small part in making possible.

THE CV

PRESENT INDEPENDENT DIRECTOR, BNY MELLON CSD AND INDEPENDENT NON-EXECUTIVE DIRECTOR, EUROCCP

2013 SENIOR ADVISER, SIA/COLT

2007-12 PROGRAMME BOARD MEMBER, EUROPEAN CENTRAL BANK

2004-07 HEAD OF MARKET REFORM, LLOYD’S OF LONDON

2003-04 EXECUTIVE DIRECTOR EMEA, COMPUTERSHARE

1999 AWARDED A CBE

1993-02 CHIEF EXECUTIVE, CRESTCO

1973 GRADUATES FROM UNIVERSITY OF OXFORD’S MAGDALEN COLLEGE WITH DOCTORATE IN SOLID STATE PHYSICS



Ringling the changes

FROM PROVING PRICE TRANSPARENCY TO RECORDING TELEPHONE CALLS RELATING TO ORDERS, FIRMS WILL HAVE THEIR WORK CUT OUT TO ENSURE THEY MEET THE REQUIREMENTS OF THE MARKETS IN FINANCIAL INSTRUMENTS DIRECTIVE II (MiFID II)

◆ JOHN SHERROCKS

To describe MiFID II as a once-in-a-generation directive would not be an exaggeration. It is three-pronged: a response to the financial crisis, a catch-up exercise in the wake of the host of technological advances since the introduction of MiFID I in 2007, and an attempt to break down national boundaries within markets. All three factors are driving different elements of the directive to create the proverbial perfect storm for firms and their operations.

Extending as it does regulatory requirements to far more venues and product sets than its predecessor, MiFID II is expected to be an extremely costly exercise, posing significant operational and strategic challenges.

Despite the looming 2017 deadline, companies have, in many instances, been forced to sit on their hands because of the absence of detailed rules, although it is hoped that much will become clear before the end of this year. The extent of firms' preparation depends on the size of the operation and the type of business. Wholesale sell-side businesses will be harder hit than retail firms, with the directive intent on expanding market regulation and systematic internalisers (SIs).

On the plus side, if MiFID II is successful in creating a true European market, cross-border investing should become easier, which would in turn benefit retail markets through lower transaction

costs from greater pre- and post-price transparency and best-execution changes.

We highlight ten ways in which MiFID II will affect businesses' operations:

1 ORGANISED TRADING FACILITIES AND OTHER MARKETS

Alongside regulated markets (RMs) and multilateral trading facilities (MTFs), MiFID II introduces an extra category of venue: the organised trading facility (OTF), which will relate only to bonds, structured finance products, emission allowances and derivatives.

Unlike a MTF and SI, the operator of an OTF will not be allowed to trade against its proprietary capital. However, as Simon ◆

Getty



Demonstrating good quality of execution on a reasonably consistent basis will mean hefty IT bills for firms

Lovegrove, Head of Financial Services Knowledge – Global at Norton Rose Fulbright, notes: “There will be an exception specifically for OTF operators in relation to sovereign debt instruments for which there is no liquid market.”

A further big shift will be the requirement on markets to permit clearance by any central counterparty (CCP), and for CCPs to clear trades on any market – contrary to the ‘vertical’ structure of some exchanges.

2 TRANSPARENCY AND TRANSACTION REPORTING

The transparency and transaction reporting obligations in MiFID II will be considerably expanded to apply to each type of trading venue, albeit calibrated for various types of instruments and trading. Also included are financial instruments traded on an OTF or whose value depends on such an instrument.

Perhaps one of the key points is that its associated regulation, MiFIR, imposes an entirely new transparency regime for a wide range of non-equity instruments. “The majority of the implementing measures for this new regime will take the form of regulatory technical standards,” says Lovegrove.

Whole new IT systems will be needed, too, in order to furnish and distribute a continuous price for pre- and post trades. There are concerns that the transparency obligations for non-equity instruments, such as bonds and derivatives, may result in a

significant reduction in market liquidity. Another potential problem rests in having to identify, for reporting purposes, the individual who made the investment decision and the trader who executed the transaction. Position reporting for commodities’ derivatives will also be a big change.

3 TRADING OBLIGATIONS

To meet transparency requirements, investment firms will need to ensure that trades in shares admitted to trading on an RM, or traded on an MTF, only take place on an RM, MTF, SI or equivalent non-EU trading system.

“An investment firm may execute a trade elsewhere but only if the trade is non-systematic, ad hoc, irregular and infrequent, or if it is carried out between eligible counterparties (ECPs) and/or professional counterparties, and does not contribute to the price-discovery process,” explains Lovegrove.

The push onto trading venues also applies to standardised over-the-counter (OTC) derivatives, particularly many of those settled through a central counterparty under European Market Infrastructure Regulation (EMIR), designed to increase the stability of (OTC) derivative markets in the EU.

4 HIGH-FREQUENCY TRADING (HFT) AND ALGORITHMIC TRADING

Essentially, market makers are going to have to put up quotes in bad as well as good trading conditions. Far more detailed

records will need to be kept and markets will have much greater responsibility to supervise and monitor HFT firms.

For the first time, trading platforms (and investment firms) will be subject to an EU harmonised regulatory regime specifically relating to HFT and algorithmic trading, market making and direct electronic market access.

5 SYSTEMATIC SI REGIME

MiFID II extends the SI regime so that it applies not just to shares but also equity-like instruments (depository receipts, exchange-traded funds, certificates and other similar financial instruments) and non-equity instruments (derivatives, bonds, structured finance products and emission allowances). The directive also introduces a new definition for an SI, which is based on quantitative criteria for assessing when the activity of dealing on own account by executing client orders is sufficiently frequent, systemic and substantial.

6 CONDUCT OF BUSINESS

The need to demonstrate good quality of execution on a reasonably consistent basis, together with the associated reporting to clients, will mean a hefty IT bill for affected retail firms.

“There are a number of changes to the conduct of business requirements which, when taken together, culminate in significant regulatory reform,” points out Lovegrove.

These include:

- a stricter requirement on firms to prevent conflicts of interest from arising in the first place, instead of merely relying on managing identified conflicts;
- a complete ban on inducements being received in certain circumstances, eg, by discretionary managers;
- more onerous information requirements on investment firms, particularly in their dealings with ECPs.

Although it does not set out major changes to the best-execution requirements, MiFID II imposes several additional requirements on investment firms. One is that the execution policy must be provided in sufficient detail and in clear, easy-to-understand language. Another is that firms must summarise and make public on an annual basis, for each class of financial instrument, the top five execution venues where they executed client orders in the preceding year.

The suitability requirement has been enhanced by the introduction of an obligation on firms to obtain information about clients' risk tolerance and ability to bear losses, and confirm the basis for the advice in writing.

7 RECORDING OF TELEPHONIC AND ELECTRONIC COMMUNICATIONS

Investment firms will need to record telephone conversations or electronic communications relating to the following investment services: reception and transmission of orders, execution of orders on behalf of clients, and dealing on own account.

The investment services affected are: (i) the receipt of an order from a client; (ii) the transmission of an order (both where the investment firm will transmit the order, and where it will execute it); (iii) the conclusion of a transaction when executing orders on behalf of clients; and (iv) the conclusion of a transaction when dealing on own account, regardless of whether a client is involved in the transaction.

Records will need to be kept for five years instead of the current six months, which has raised concern over the cost of storage and data retrieval systems.

8 THIRD COUNTRY

MiFID II, together with MiFIR, creates a harmonised regime for non-EU investment firms wishing to do business in the EU with professional clients and ECPs. A non-EU firm may provide investment services to ECPs and per se professional clients on a cross-border basis where they are registered with the European Securities and Markets Authority – meeting equivalence requirements in regulatory regimes.

Firms wishing to promote investments to retail clients and opted-up professionals will need to set up an EU branch as well. This will overrule current UK exemptions.

9 SMALL AND MEDIUM-SIZED ENTERPRISE (SME) GROWTH MARKETS

MiFID II aims to facilitate access to capital for SMEs and the development of specialist markets catering for their needs. Lovegrove emphasises: “MiFID II requires that at least 50% of the issuers whose financial

instruments are admitted to trading on an MTF registered as ‘SME growth markets’ are SMEs at the time of registration, and in any calendar year thereafter.”

10 DARK POOLS

Dark pools – alternative trading systems which allow investors to buy and sell shares anonymously, so that their trading activity is hidden from rivals – will be allowed to trade up to only a certain maximum percentage of the equity of a listed company.

The key question is how does a dark pool know when to cut off trading in a particular equity? For now, it is a case of ‘watch this space’.

➤ Further information

CISI Professional Refresher: MiFID II – cisi.org/refresher. CPD training course: MiFID II and the New Regulatory Structure, next date 19 November – cisi.org/courses



Playing it extra safe

THE FCA HAS CHANGED THE RULES OF ITS CLIENT ASSETS REGIME TO HELP PROTECT CUSTOMERS AND THEIR ASSETS

◆ CHRIS ALKAN

In 2012, the FCA promised a “radical” shake-up of its rules governing client assets. Yet the package of changes the regulator published in June this year was not quite the revolution the watchdog had told the industry to expect.

Even so, there is plenty in the reforms being introduced by the FCA to keep wealth managers, custodians and other financial institutions busy. A raft of new rules and guidelines came into force on 1 July this year and others will follow this December and in June 2015.

The first observation for financial firms regards what is not happening. Part of the original goal of the overhaul was to improve the speed with which client assets were paid back in the event of a financial institution collapsing. Following the meltdown of American investment bank Lehman Brothers in 2008, some British customers endured a wait of several years before they recovered assets or cash – far longer than peers on the other side of the Atlantic.

The initial plan was to speed this up by paying out the bulk of money almost immediately based on the firm’s own records, leaving a smaller portion for later claims. To do this, it was important to make changes to ensure the information kept by firms is spot on. “A key focus of the updated rules is to ensure that firms’ records are complete and accurate,” says Amanda Sherwood MCSI, an independent business consultant and Client Asset Sourcebook (CASS) specialist. “Firms will face tougher rules on protection of client assets and client money, and clients will be entitled to greater

clarity about where and how their assets are being held. But there is nothing here yet to dramatically accelerate how quickly they will get their cash and assets back.”

NEW LEGISLATION

Changes may be made later to accelerate the process, experts point out. “Work is being done by the Treasury so it seemed sensible to hold fire,” says Hannah Meakin, a partner at Norton Rose Fulbright. “If there is new legislation on the way, any FCA rule changes on speed may have been superseded and would have had to be revised anyway.”

In the meantime, however, there are plenty of steps financial institutions that handle client money need to take. These include giving clarity to customers over the terms in which their assets are being held, explains

“A broker should consider whether it is appropriate to put all the clients’ money and assets with a single institution”

Christopher Bond, Chartered MCSI, Senior Adviser at the CISI. He says: “Clients must be provided with much more information whenever a financial institution accepts cash or assets from them. For example, it needs to be spelt out more clearly when clients actually give up title to certain assets when they post collateral. The evil this is intended to address is that customers were sometimes not aware that they risked losing collateral when a financial institution collapses.”

This point is underlined by Meakin. “There is a far clearer requirement that clients be kept up to date with exactly how their cash and securities are being held, and whether it is in custody or held as client money or not,” she says. “This right to disclosure will be applied to all clients, including the big institutions.”

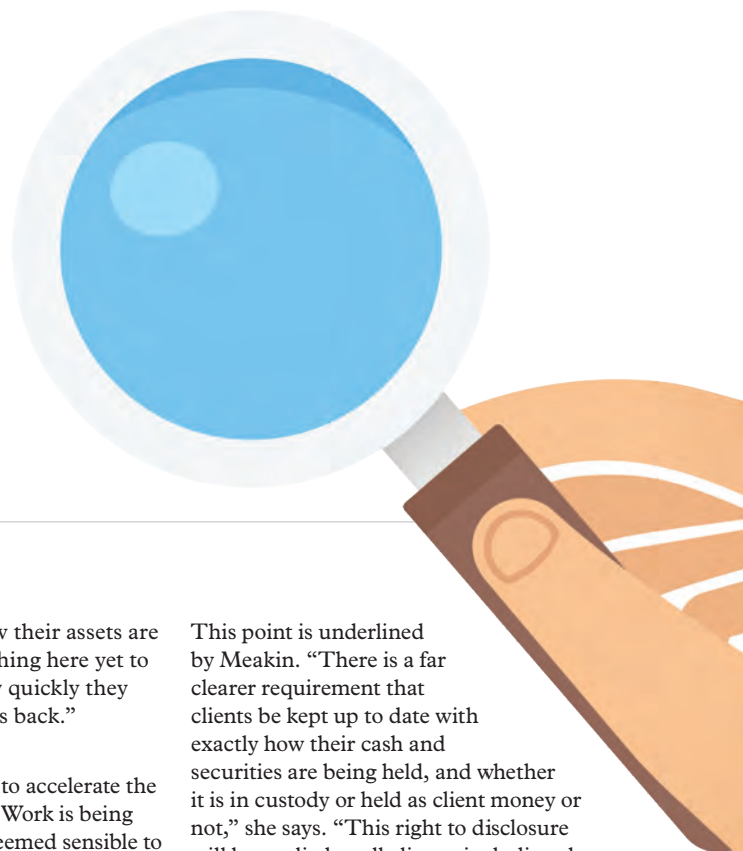
Again, the new rule is intended to avoid some of the pitfalls exposed when Lehman and MF Global collapsed. “Some customers had assumed that their cash was being held in client accounts and they were therefore eligible to draw from a separate pot of money not available to other creditors,” she says. “For some, this turned out not to be the case.”

To reinforce this new transparency, communication with clients will be more regular and frequent.

“Previously, clients would often get this information only upfront and in the event of a significant change,” Meakin explains. “Now they will be reminded about the exact details of the situation every time they receive a statement of assets from their financial institution.”

RELIABLE RECORDS

For many firms, the real meat of the change relates to ensuring that records of client assets are completely reliable and up to date. “The FCA has found numerous instances of poor record-keeping practices, and it is taking action to tighten the rules on reconciliations in particular so that firms regularly check their records to ensure they



are complete and accurate,” says Sherwood. “The new rules carefully define a standard approach to reconciliations; firms may use a different method but their auditors must confirm that the method is suitable.”

A key part of the process is making sure financial institutions conduct an internal reconciliation on the client assets they are responsible for. “Where companies only keep a single set of records, they must confirm that systems and controls are in place to guarantee the accuracy of their files,” emphasises

Sherwood. External reconciliation – making sure a firm’s records are in line with external bodies, such as custodians – is also required.

Some provisions are likely to affect only the smaller financial institutions that until now have relied on outside systems to keep

their records. “Under the more rigorous system being brought into force, such businesses will now have to maintain their own internal records,” says Sherwood.

There are requirements, too, for firms to leave a clear trail of actions taken to keep their affairs in order. “Institutions will need to record the dates on which they conducted internal and external reconciliations or due diligence when depositing cash with another bank,” says Meakin. “So it is not just about what you hold, but the reasons why and all of the actions you have performed. The result is a much longer audit trail.”

THIRD PARTIES

The FCA is also insisting on more thorough due diligence on third parties that wealth managers or brokers use to hold cash or assets for their clients. To further reduce the risk of losing client money, the Authority is encouraging greater diversification. “The idea is that a broker should consider whether it is appropriate to put all the clients’ money and assets with a single institution,” Meakin explains.

Of course, many firms that were already following best practice will be little affected. “For these businesses, there is nothing terribly onerous in this aspect of the changes,” says Meakin. “For others, it may require new IT systems and a deep overhaul of procedures.”

Finally, firms will need to consider a shift in the system for over-the-counter derivatives. As of 1 July 2014, client collateral can be placed either in individual accounts, omnibus accounts of all clients or a smaller sub-pool.

“As a result, there is a lot more information that clients need to receive about these options,” says Bond. Although these changes seem bureaucratic and incremental, they should increase the safety of client assets. They also lay the foundations for greater speed. If records are more reliable, it should ultimately be easier for clients to be repaid faster when institutions go bust.

Further information

- CISI Professional Refresher: Client Assets and Client Money – cisi.org/refresher
- CPD training course: Client Assets and Client Money, next dates 8 October and 3 December – cisi.org/courses

PAPER CHASE

The clock is ticking for financial institutions to meet one of the key challenges of the FCA’s new rules governing client assets. Under the

regulations, firms need to secure acknowledgment letters from banks that the cash they are holding belongs to clients, rather than the wealth managers or brokers that make the deposits.

This gives clients more security in the event of a collapse, since their wealth is legally separate from that of the firm and its bankers. This is particularly important where the bank is subject to a foreign jurisdiction. To avoid any confusion, the FCA has devised a standard template for such letters.

“The result is that a vast repapering exercise has to be done,” warns Christopher Bond, Chartered MCSI, Senior Adviser at the CISI. “This has to be completed by 1 December 2014 for new client accounts and by 1 June next year for existing ones. This deadline sounds generous, but it involves contacting a large range of financial institutions, many of which may be overseas.”

Even mid-sized brokers will have dozens of accounts at different financial institutions, so for many firms, there is much to be done by December.

A capital idea?

ECONOMIST THOMAS PIKETTY HAS CAUSED A STIR WITH HIS VIEWS ON INCOME INEQUALITY, BUT HOW VALID IS HIS ARGUMENT, AND IS THE GLOBAL WEALTH TAX HE PROPOSES REALISTIC?

◆ ANDREW DAVIS 📷 REX FEATURES

The terms ‘rock star’ and ‘economist’ are strange bedfellows at the best of times. Recently, however, they have frequently appeared in the same sentence, thanks to a previously obscure French economics professor who has written a 700-page bestseller on inequality. It might not sound like the stuff of rock-star adulation, but since *Capital in the Twenty-First Century* appeared in English in April, 43-year-old Thomas Piketty has attracted extraordinary levels of attention.

Piketty toured the US to promote the book, meeting Treasury Secretary Jack Lew, addressing the White House Council of Economic Advisers and giving lectures at the International Monetary Fund and the United Nations. In the UK, he met with Labour leader Ed Miliband’s economic advisers, while his June lecture at the London School of Economics (LSE) was packed.

Piketty’s work has attracted largely positive comment from the world’s top economists. But above all, his central idea – that wealth in our societies is becoming less equally distributed so the wealthiest see their share increase – has struck a powerful chord with the public. However, his book has also provoked strident criticism, particularly from right-wing commentators in the US.

Piketty, in their view, is an enemy of capitalism.

Growing income inequality has been discussed in countries such as the UK and the US for years, thanks to big increases in rewards for top executives, while average earnings have stagnated in real terms. Piketty’s book, however, sets out to look beyond earnings as it examines how and why inequality rises and falls. “What my book is trying to do is shift attention from income to wealth,” Piketty told his audience at the LSE. “But of

“We can adapt our policies and in particular our tax rates in order to democratise wealth and have more diffusion of wealth”

course both are important... To some extent, wealth inequality flows from income inequality.”

Capital – private financial and property assets net of borrowing – is therefore his main focus and his work in this area has attracted attention for a number of reasons. First, Piketty and his academic collaborators have assembled a huge database plotting how capital has been distributed across the societies

of more than 20 countries over periods of up to two centuries.

This unique data-gathering exercise has allowed Piketty to claim that he is replacing economic theorising on inequality with verifiable data. Second, he has drawn some startling conclusions from the data. In particular, he says wealth inequality in some developed economies is returning to levels last seen at the start of World War I, when a very small number of people held a huge share of the capital.

In 19th-century Europe, he says, the wealthiest 10% of the population owned 90% of the capital, with two-thirds of that share concentrated in the top 1%. Today, the wealthiest 10% hold 60% to 70% of the capital, and a middle class, accounting for about 40% of the population, holds 20% to 30%. Piketty argues that in recent decades, the share of the top 10% has started to increase.

His explanation for the decline in wealth inequality after World War I falls into two major parts. First, a great deal of wealth was destroyed by the two world wars and the Great Depression. Second, rapid economic growth after the end of World War II helped the middle 40% of the population to accumulate a greater share of the wealth.

Rates of economic growth are central to Piketty’s argument.

At the heart of his book is the formula that he advances to explain the fundamental process by which wealth inequality rises or falls. This formula, ‘ $r-g$ ’ (where ‘ r ’ is the after-tax rate of return on capital and ‘ g ’ is the rate of economic growth), suggests that where the return on capital is higher than the overall rate of growth in an economy, the wealthy will tend to see their share of the capital increase. The more capital they hold, the faster their share will grow.

SAVINGS RATES

Professor Alan Manning of the LSE has published extensively on inequality, and cautions that other factors, such as savings rates and how far fortunes are broken up on death, will also affect the outcome. “It’s a bit more complicated than that,” he says.

Piketty suggests that for countries experiencing prolonged periods of very slow economic growth, the effect could become marked, because wealth built up by individuals in the past will continue to grow faster than the economy, thereby entrenching inequality.

In terms of his formula, when ‘ g ’ is stuck at a very low level, it is easier for ‘ r ’ to surpass it by a wider margin.

His attempt to capture the way in which wealth inequality grows seems to have won acceptance



among economists. Its real value, says Manning, is to show that free-market systems do not necessarily produce stable outcomes and can in fact enable inequality to grow over time rather than decrease. Far more controversial, however, has been Piketty's suggestion that a global tax on wealth will be necessary to prevent the inequalities growing to potentially dangerous levels.

TAXING WEALTH

Paul Johnson, Director of the Institute of Fiscal Studies, holds out little hope of a successful worldwide attempt to tax wealth. "A wealth tax would be some percentage of the worldwide totality of an individual's assets," he says. "Making it work would be extraordinarily difficult. You would need to get every country in the world to sign up to it and that's not going to happen."

So does it follow that nothing can be done? Not necessarily, says Johnson. "We don't do very much in the way of wealth tax in the UK. The only one of any substance is inheritance tax, which is pretty ineffective at getting at that top half per cent," he says. "I don't think we've looked very seriously in the UK at how we might make inheritance tax work better."

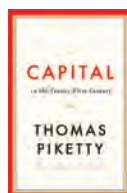
Similarly, Johnson argues the UK's other main tax on capital, council tax, is regressive. Talk among the main political parties of a 'mansion tax' on expensive properties therefore represents a move in the direction Piketty is pointing towards. "You could see a mansion tax as one step

towards improving council tax," says Johnson.

Even Piketty has acknowledged that a global wealth tax has little hope of being implemented. But Manning argues Piketty's other suggestions are more feasible: notably better information on who the holders of capital are and what they own. Given that a big part of the problem in mapping the distribution of capital is, as Johnson says, that "the data isn't marvellous", Manning may have a point.

"One of the reasons inequalities of wealth have crept up on us ... is that people have not been interested in recording it," says Manning. "That's because the Government only wants to record things it taxes and it hasn't really wanted to tax wealth in the UK except at death." To some extent this is changing, such as in the global effort to force greater transparency on former tax havens, but there are still big gaps in the data.

"We need more democratic transparency," Piketty told the LSE, "and we need adequate democratic and fiscal institutions so that we know better how this is evolving over time, and we can adapt our policies and, in particular, our tax rates in order to democratise wealth and have more diffusion of wealth. The point is not to reduce the wealth-to-income ratio per se, but rather to try to make sure that the share going to the middle class and lower groups in society rises rather than shrinks."



READER OFFER

Readers can purchase *Capital in the Twenty-First Century* at the discounted price of £20 (not including p&p). You can place your order by phone or email:

Phone: +44 1243 843291

Email: cs-books@wiley.com

To obtain your discount you will need to quote the code **H0129**. The offer is valid until 29 September 2014.

WITH CPD BECOMING FAR MORE OF AN EVERYDAY FEATURE OF LIFE IN FINANCIAL SERVICES, ADVISERS AND FIRMS ARE BUSY CONSIDERING HOW BEST TO DOVETAIL TRAINING AND COMPETENCE REQUIREMENTS

◆ HEATHER CONNON

Continuing to evolve

“Continuing professional development (CPD) is arguably as important as modernising qualifications – particularly if advisers are to continue to meet the future challenges and demands of the investment market.” Those are the words of the Financial Conduct Authority (FCA) in its guidelines on professional standards. Advisers and investment managers, who are becoming accustomed to life after the Retail Distribution Review (RDR), will be well aware of just how crucial CPD is to the regulatory regime.

The Statement of Professional Standing (SPS), which is issued annually by the accredited body provided CPD and other application requirements have been met, will be familiar to anyone used to recording

objectives, activities and outcomes in training logs from the pre-RDR days. The SPS has regulated the CPD requirements for advisers and investment managers in the retail sector to obtain the professional standard. It means that if you don't have the SPS, you cannot continue to practise as a retail adviser. Of the 35 hours of CPD required under the SPS, 21 of these hours must involve structured learning.

The introduction of a regulatory requirement for retail advisers to undertake CPD brings a feature of life in other professions, such as accountancy, firmly into the financial services arena. Much of the industry was already subject to training and competence (T&C) requirements, although under this regime, firms verify that their employees are

up to scratch without the need to demonstrate or commit to undertake a formal programme of CPD. However, the changes that RDR brought to the retail advisory market are having wider effects across the industry, says CISI Managing Director Ruth Martin: “The RDR has been an engine for the great growth of interest in CPD. These changes have really propelled CPD to be a very significant feature of life in financial services way beyond those that are directly regulated as individuals.”

It is also clear, she says, that regulation is reinforcing this trend, for example in areas such as banking. In a consultation paper published in late July entitled *Strengthening Accountability in Banking: A New Regulatory Framework for Individuals*, the

FIVE TOP TIPS FOR PROFESSIONAL DEVELOPMENT

Plan ahead: Conduct an annual skills audit for yourself. Think about the areas where you have identified gaps in your knowledge and consider whether new legislation, rules, product developments and other changes have affected the area in which you operate.

Set your training goals: Work out a training regime to meet the requirements of your annual audit, but remember to allow time to cover unexpected developments during the year.

Use all available resources: Technology makes it easier to fit training into your schedule, through webcasts and computer-based training. Take advantage of the resources available from accrediting bodies like CISI. Be creative; watching a well-informed broadcast on the impact of

Islamic insurgency in the Middle East can be a very useful way of updating yourself on how to assess market risk.

Spread out your training over the year: CPD training should be properly structured over 12 months. Remember the analogy of the footballer who trains every day to stay at the top of their game.

Work with others: Your company may have 400 investment managers whose basic CPD requirements will be similar, so organising company-wide courses may be an efficient use of resources. This will need to be topped up with more personally tailored training.

• Learn about the CISI CPD scheme at cisi.org/cpdscheme

FCA set out proposals to amend the approved persons regime following the publication of the Banking Standards Review. This includes a recommendation that “firms must assess the fitness and propriety of those in the certification regime annually”.

“We would argue that this proposal has to include CPD and we suspect firms will see it as CPD too,” says Martin.

It seems clear, therefore, that CPD is going to become a much more everyday feature of life in financial services, partly due to regulation and partly because firms will voluntarily choose to encourage staff to undertake it even if they are not formally required to do so.

There are concerns that some firms regard T&C as being equivalent to CPD, even though T&C is concerned much more with the basic rules that govern staff’s activities than with the broader and evolving knowledge of products and markets that formal CPD implies. However, Martin suggests this

“It’s about taking responsibility and ensuring that you are the best you can be in the role”

attitude is not universal. “Some firms will say it’s not just about what the regulator says. CPD isn’t just about compliance. It’s about taking responsibility and ensuring that you are the best you can be in the role you are in.”

PART OF THE PROCESS

The essential point is that CPD should not be seen as an end in itself, done merely to tick the relevant requirements, but as part of the process of ensuring that the financial services industry in retail and beyond provides a professional service that customers can trust to deliver what they need. The way that dovetails with the training and competence requirements is now starting to exercise the minds of advisers and firms.

Andrew Cork MCSI, Senior Compliance Manager at Charles Stanley, uses a sporting analogy. “Professional athletes put in hours of practice each day to reach the top of their game and that is the way financial planners and investment managers should view their profession too. While there may have been a temptation in the past to simply tick the boxes, the need to demonstrate skills is now explicit in the regulated environment.”

Judith Ullock, Chartered MCSI, Training Manager at Redmayne-Bentley, says it is



Getty

WHOLESALE CHANGES NEEDED

By formalising the requirement for CPD to be mandatory for financial advisers in the retail sector, the RDR has widened the gap that already exists between the requirements of those on the retail side and those in wholesale.

If a firm carries out only wholesale activities, the FCA's training and competence (T&C) regime does not apply to them. Although the FCA suggests that firms operating solely in the wholesale sector refer to its Senior Management Arrangements, Systems and Controls (SYSC) sourcebook when considering how to meet the high-level requirements

in SYSC, these firms are under no obligation to fulfil the requirements.

The CISI has long questioned the wisdom of abolishing mandatory qualifications for the wholesale market. The Institute believes it cannot be tenable in the long term for the wholesale sector to have significantly lower standards than the retail market, especially in terms of qualifications, CPD and ethics. The widening gap in requirements between retail wholesale not only undermines standards, but also makes it harder for financial advisers to build a knowledge base that they can transfer from one sector to the other, argues the CISI.

necessarily undertaking the kind of training they really need to do. "There is still an element of feeling it is something they need to do [to comply], rather than something with a pre-defined end in mind: for example, learning about structured products."

Moland thinks firms can help their employees in this regard by encouraging them to see training as part of the job, releasing them from work commitments where necessary. He adds that institutes such as the CISI are making greater use of technology, for example by putting webcasts of conferences and seminars on the internet to help those who could not attend catch up. While Moland is not formally required to do CPD as he is a compliance officer, he chooses to do so to ensure he keeps up to date.

OTHER SYSTEMS

CPD is required by most other professions but other systems have evolved in different ways. The Institute of Chartered Accountants in England and Wales (ICAEW) does not insist on a set number of hours but requires: "As much development activity as you feel is required to remain competent in your role." This can include anything from reading the Institute's email

What type of reading should be classified as CPD? Does the Financial Times count?

alerts for news and updates relevant to your role and participating in the ICAEW community to formal training courses. The Law Society requires 16 hours, while doctors' CPD requirements vary according to their Medical Council.

While the ICAEW's CPD philosophy sounds rather casual, its stricture is worth bearing in mind: the RDR requires advisers to know the market on which they are advising their client. That means being equally familiar with the more esoteric areas as well as mainstream products. Keeping abreast of them requires more than just keeping up to date with money laundering rules; it means embracing CPD as a way of life.

Further information

CISI Professional Refresher: Training & Competence/Training & Competence Supervision Essentials - cisi.org/refresher. CPD training course: Training & Competence Health Check, next date - 15 October - cisi.org/courses

important for firms to have best practice measures and systems and controls that ensure individuals meet their regulatory requirements as well as aid their own personal development. "In addition to this, firms need to ensure that any training put in place is firm-wide, supporting both regulatory and non-regulatory requirements, and that both front- and back-office functions are covered," emphasises Ullock. "It is also important to ensure that any training carried out

meets the firm's business objectives and is in line with the business plan."

CLASSIFYING ACTIVITIES

The concept of unstructured CPD, which can make up 14 of the 35 hours' minimum requirement, is encouraging firms and advisers to think carefully about the kinds of activities which can – or indeed should – be counted as part of development activities. The FCA itself says reading can form part of unstructured learning, and the CISI's own rules recommend a maximum of five hours. But what type of reading should be classified as CPD? Does reading the *Financial Times* daily count? Is it a requirement to keep up to date with financial markets and economic trends? Is attending the firm's weekly asset allocation meeting just part of the job or does it actually add something to professional development?

Cork says he spends a great deal of time examining FCA guidance, consultation papers and professional updates but he describes most of this as business-as-usual activity in order to be in a position to offer advice. "CPD can be personalised as well as formal or structured. An investment manager will need to keep up to date with modern retail practice and the tools he uses. For example, if he uses a risk tool, he will need to model the application of that tool and how it informs the client experience."

David Moland, Chartered FCSI, Head of Compliance at Arbuthnot Latham, believes that the advent of the SPS has encouraged registered individuals to focus much more on CPD, but he believes that people are not



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CONTENTS

Do contrarian dogs have any teeth? A contemporary investigation of the 'Dogs of the Dow' strategy - Paul Stewart and Michael Thompson, University of Ulster	2
The technology transfer of Quality Function Deployment (QFD) from engineering into investment management - Rob Fullman ACSI, University of Plymouth	5
Governance, conduct costs and equity performance in financial services: recent evidence of large financial institutions - Dr Edward Bace, Chartered MCSI, Middlesex University Business School, London	9
Submission guidelines/ list of journal panel members	12

EDITORIAL

What with Western economies finally showing concrete signs of emerging from the depths of the 2008-2009 recession (two good examples: US GDP growth rates at 3% quarter-on-quarter and UK economic output back to a level above that recorded in 2008), central banks are remembering again their monetary policy mandate and, ever so slowly, thinking about inflation and interest rates.

This was always going to be a snail's pace process. When one has uber-doves such as Janet Yellen and Mark Carney at the helm, and Mario Draghi promising to do whatever it takes to stabilise the eurozone (it's so much easier to spend other people's money), it was always apparent that the 'Big 3' central banks were never going to even start to remove policy accommodation until they were absolutely certain that economic growth was here to stay – at least for the next few years, at any rate. (Not that it has ever been an official mandate of any of them to conduct monetary policy only when strong and sustainable growth was being recorded. The preservation of the value of their country's currency, on the other hand, is part of their official mandate, and in the case of the Bank of England its only publicly stated objective. Quite how several years of zero interest rates, trillions in money-printing and continuous rounds of three-year funding for low-quality collateral squares with the money preservation mandate is beyond me. For those interested in the implications of this new approach to central banks, I heartily recommend Professor Dimitris Chorafas's excellent and incisive book *The Changing Role of Central Banks*.

But now even the doves recognise and accept that interest rates will start to rise in 2015, in the US and UK at least, and most likely in 2016 in the eurozone. So investors and traders alike are exercising their minds with the question: in the era of 'new-normal' what will the interest-rate cycle look like? What is the peak rate this time around? This is an important question, because the answer (or surmised answer) will influence all manner of investment and capital budgeting decisions. How much more likely would you be to take out a mortgage if you knew that central bank interest rates over the next five to seven years were never going to exceed 3.5%, as opposed to 6.5%?

Forecasters are hindered by the peculiar circumstances surrounding monetary policy-setting this time around, more or less without precedent. The chart shows the US dollar five-year implied forward rate over the last seven years, derived from the spread between five-year and ten-year US Treasury bond yields. It is difficult to draw firm conclusions from it. At the moment the graph appears to suggest that around 3.5% will be the top of the cycle this time around, and this is not a bad surmise for both US dollar and sterling interest rates. But look closely at the chart and it reveals an unsurprising feature: as economic sentiment picks up, so does the implied base rate in five years' time; as sentiment turns negative so do rate expectations. In other words, as the positive market statistics we

are observing on both sides of the Atlantic continue to remain positive, be they related to unemployment, inflation, house prices or GDP growth, then interest rate expectations will get more bullish. The 5% peak base rate implied at the turn of 2009-10, just before the eurozone Grexit crisis befell us, should return.



Figure 1 US dollar five-year forward rate expectations, 2007-2014 (Source: US Treasury yields, Bloomberg)

But this would almost certainly be overdone. The new, unstated role of central banks appears to be underwriting the private sector at taxpayers' risk. It appears central banks see themselves as the guardians not just of their currency's value, but also of economic stability and growth itself. A 5% base rate in (say) four to five years' time is probably unthinkable for them, and at the merest whiff of market instability the 'Big 3' central banks will probably start cutting again. On balance, a peak base rate of no more than 4% should be expected.

This quarter we're pleased to bring you three diverse and wide-ranging but very topical articles on different aspects of the markets. Messrs Stewart and Thompson present a renewed look at the 'Dogs of the Dow' strategy for fund management made popular at the turn of the century, but find no strong evidence arguing for its renewed inclusion in current practice. Rob Fullman on the other hand has considered a completely novel approach, the application of Quality Function Deployment technique, a common practice in engineering, to investment management. An hypothetical application exercise suggests such a technique may carry some value. Finally Dr Edward Bace has looked at large banks' conduct risk costs and share price performance, and the results are notable if not necessarily conclusive. They are also, to an extent, counterintuitive: spend more on conduct risk practices, for instance, and your financial results should improve. This finding is worthy of further investigation.

I hope you enjoy this issue.

Professor Moorad Choudhry FCSI, Editor

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

DO CONTRARIAN DOGS HAVE ANY TEETH? A CONTEMPORARY INVESTIGATION OF THE 'DOGS OF THE DOW' STRATEGY: SOME UK EVIDENCE, 2000-2012.

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ABSTRACT

Slatter (1988) first brought to prominence a 'Dogs of the Dow' investment and equity selection strategy, attributing it with impressive claims of market outperformance. Subsequent popularisation by O'Higgins and Downes (1991, 2000) and Knowles and Petty (1992) added to the strategy's appeal in the investment community. Academic attention has been relatively limited, and not entirely supportive, as to the veracity of these claims, particularly after consideration of taxes and transaction costs. This paper re-examines the 'Dogs' strategy based on FTSE100 and FT30 stocks in the previously unexamined 2000-2012 period during which time there was much turbulence in the markets. This period encompassed the 'dotcom' bubble of 2000-2002, the financial crisis of 2008 and on and the period of strong economic growth of the mid-2000s. Our results are not supportive of statistically or economically significant residual returns.

LITERATURE REVIEW

Original development

Slatter's original 'Dogs' strategy (1988) was popularised in the Wall Street Journal article of that year which outlined his basic proposal: select an equally weighted portfolio comprising the ten highest-yielding Dow Jones Industrial Average (DJIA) listed stocks which would be held for one calendar year after which, on each anniversary of the portfolio formation, both the portfolio and the DJIA list would be re-examined and rebalanced to include the then highest-yielders from the Dow listing. The 'Dogs' strategy itself is predicated on the notion that DJIA companies are reluctant to cut their dividends and that the high-yield measure simply identifies the temporarily unfavourable stocks whose prices had temporarily fallen. Slatter claimed that this strategy had produced returns in excess of the DJIA index by an average 7.6% per annum in the period from 1972-1988 and these claims were followed up with similarly impressive claims by O'Higgins and Downes (1991, 2000) and Knowles and Petty (1992) who suggested equally impressive potential for this investment strategy. O'Higgins and Downes (2000) further suggested complementary strategies involving five and single stock portfolios which they claimed had the potential to produce similarly impressive returns. These expositions consistently claimed that a 'Dogs' strategy had the potential to systematically outperform the Dow but did suffer the obvious weakness that the claims were based on naïve non-risk-adjusted returns which did not account for taxes and transaction costs. Inevitably, Slatter's strategy attracted academic attention.

US studies

McQueen, Shields and Thornley (1997) examined Dow stocks from 1946-1995 and concluded that the 'Dogs' strategy outperformed the market index by 3.06% on average. However, they found that when significant rebalancing costs and taxes were factored in to their results, this apparent abnormal return evaporated and, further, when their 50-year test period was broken down into ten-year sub-periods, the 'Dogs' strategy dominated the market in only two out of five sub-periods. Examining a similar period, Domain, Louton and Mossman (1998) applied a 'Dogs' strategy to Dow listed stocks

from 1964-1997, but compared performance relative to the S&P500 index. This study concluded that the 'Dogs' strategy outperformed the S&P index by an average of 4.8% per annum. Domain et al went further and examined portfolio performance in the 12 months before portfolio formation and found that their portfolios had underperformed the index by an average 3.7%. They concluded that this finding (and the apparent 'Dogs' outperformance) may have been due to the so-called 'winner-loser' effect proposed by De Bondt and Thaler (1985). These studies were closely followed by Hirschey (2000) who examined the 'Dogs' strategy on US stocks from 1961-1998, but found only a modest average annual outperformance of 1.8% which disappeared after accounting for taxes and transaction costs. Hirschey also documented significant periods during which the 'Dogs' strategy distinctly underperformed the market and concluded that the results of previous studies may have been the result of judicious selection of the time periods chosen for examination.

International studies

Visscher and Filbeck (2003) examined the 'Dogs' strategy on stocks drawn from the Canadian market (Toronto-35 index) from 1988-1997. In contrast to the US studies, they concluded that this strategy produced significant annual average abnormal returns of 6.62% and that these were returns which higher tax and transaction costs would not dissipate.

In the UK, Filbeck and Visscher (1987) examined FTSE100 companies from 1985-1994 and concluded that the 'Dogs' strategy had actually underperformed the market index by an annual average of 2.10% during this time and had, in fact, outperformed the market in only four out of ten years. Ap Gwilym, Seaton and Thomas (2005) conducted a more extensive study of the 'Dogs' strategy applied to stocks of the FT30, FTSE100, FTSE250 and FTSE300 from 1980-2001. The results of this work concluded that the modest annual outperformance would not compensate for higher risk, tax and transaction costs necessitated by this strategy. Clearly, on the basis of this small sample of studies, results suggest that the 'Dogs' strategy is not effective in UK markets. In another European study, Rinne and Vahamaa (2011) examined a 'Dogs' strategy on Finnish-listed stocks from 1988-2008 and found that, while such a strategy may be profitable in the Finnish market, it may not be economically significant after accounting for taxes and transaction costs.

Da Silva (2001) conducted an extensive study of the 'Dogs' strategy in a range of South American markets from 1994-1999. These results suggested that such a strategy had underperformed the Brazilian market during this time and had only very modestly outperformed in other South-American markets. In Asian markets, Chong and Luk (2010) examined a high-yield portfolio ('Dogs') investment strategy from 1992-2007 in both the Hong Kong and Hang Seng markets where they found evidence of underperformance of this strategy in the Hong Kong stock market but positive returns to the strategy when applied to constituents of the Hang Seng index, concluding that the 'Dogs' strategy may be more applicable to 'blue chip' companies.

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LITERATURE SUMMARY

Author(s)	Market/data (benchmark)	Period	Results
US-focused studies			
McQueen, Shields and Thornley (1997)	Dow Jones (DJIA)	1946-95	AAR +3.1%. Becomes insignificant when taxes and transaction costs are applied.
Domain, Louton and Mossman (1998)	Dow Jones (S&P 500)	1964-97	AAR +4.8%
Hirshey (2000)	Broad US market data	1961-98	AAR +1.8%. Becomes insignificant when taxes and transaction costs are applied.
UK-focused studies			
Filbeck and Visscher (1987)	FTSE 100 Listed (FTSE 100)	1985-94	AAR -2.1%
Ap Gwilym, Seaton and Thomas (2005)	FTSE 30, 100, 250, 300	1980-2001	Insignificant AAR
Other			
Visscher and Filbeck (2003)	Canadian (Toronto-35)	1988-97	AAR +6.62%. Taxes and transaction costs did not reduce the significance of this result.
Da Silva (2001)	Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela	1994-99	AAR -4.26% (Brazil), insignificant outperformance in other markets.
Chong and Luk (2010)	Hong Kong Stock Exchange, constituents of the Hang Seng Index	1992-2007	AAR -1.28% for the ten-stock 'dog' portfolio drawn from the HKSE. AAR +8.61% for a five-stock portfolio drawn from constituents of the Hang Seng index.
Rinne and Vahamaa (2011)	Finland (OMXH25)	1998-2005	AAR +4.5%. Insignificant after taxes & transaction costs are applied.

AAR: Average (annual) Abnormal Returns

METHODOLOGY

Our study examines FTSE100 and FT30 companies from 2000-2012 inclusive, the data for the study being derived from Datastream. This time period was specifically chosen since it had not been previously examined and it included the market turbulence associated with the 'dotcom bubble', the strong economic growth of the mid-2000s and the financial crisis of 2008 and later. Portfolios of stocks were drawn from the 'blue chip' FTSE100 and FT30 list, reflecting Slatter's original proposal which had very large cap companies in mind. We apply strictly Slatter's methodology and identify the ten highest-yielding stocks listed on the FTSE100 (FT30) and compare the performance of the subsequently formed portfolios against an index of market performance which included price and dividend-based returns of the constituent companies listed on the FTSE100. Each (FTSE 100 and FT30)

portfolio was held for one year at which time the value of the portfolio (and dividends receipts during the year) were used to calculate the return on the portfolio (ie, portfolio returns constitute both capital gain and dividend yield). Dividend receipts themselves were not deemed to have been reinvested during the year but, rather, they were used to fund any necessary rebalancing of the portfolio when the above process was repeated on each subsequent anniversary of the original portfolio formation.

Abnormal returns are scrutinised using a range of metrics. The first measure (AR₁) is a simple market-adjusted return where R_{DOG} is the return for the 'Dogs' portfolio and R_{Market} is the return on the market index.

$$AR_1 = R_{DOG} - R_{Market} \tag{1}$$

The second measure of (abnormal) return (AR₂) is calculated by applying the market model, defined below, where R_f is the risk-free rate and the portfolio beta is given by β.

$$AR_2 = R_{DOG} - R_f - \beta(R_{Market} - R_f) \tag{2}$$

The final measure of (abnormal) return (AR₃) is the Modigliani-squared (M²) adjustment where portfolio excess returns are scaled by relative portfolio and market volatility and compared with excess-market return.

$$AR_3 = (R_{DOG} - R_f) \times (\sigma_{Market} / \sigma_{DOG}) - (R_{Market} - R_f) \tag{3}$$

Where relevant, all parameters in the above models are estimated based on returns in the previous 36 months prior to the formation of the portfolio. The statistical significance of our results is tested using standard parametric tests and subject to further scrutiny using the Sharpe Ratio (considering return relative to total risk) and Treynor ratio (considering return relative to systematic risk – beta).

	R _{DOG} FTSE100	R _{DOG} /FT30	R _{Market}	AR ₁ FTSE100	AR ₂ FTSE100	AR ₃ FTSE100	AR ₁ FT30	AR ₂ FT30	AR ₃ /FT30
2000	32.09%	-6.70%	-8.23%	40.32%	36.50%	38.00%	1.53%	3.16%	5.80%
2001	11.95%	-28.11%	-14.09%	26.04%	19.80%	24.74%	-14.02%	-8.82%	-0.42%
2002	-25.10%	-32.34%	-22.17%	-3.92%	0.86%	9.25%	-10.17%	4.76%	12.05%
2003	30.77%	-21.49%	17.89%	12.88%	11.28%	3.80%	3.60%	2.43%	-2.80%
2004	20.47%	28.11%	11.25%	9.23%	10.34%	7.87%	16.87%	16.66%	11.00%
2005	32.07%	-33.08%	20.78%	11.29%	11.46%	6.26%	12.30%	15.24%	13.06%
2006	35.79%	-34.05%	14.43%	21.36%	19.26%	8.95%	-19.62%	19.76%	16.15%
2007	2.96%	8.27%	7.36%	-4.40%	-4.60%	-3.34%	0.91%	1.35%	0.48%
2008	-46.75%	-33.3%	-28.33%	-18.42%	-10.99%	8.93%	-4.97%	-9.43%	6.99%
2009	38.34%	34.62%	27.33%	11.02%	5.99%	-4.00%	7.29%	1.34%	-5.78%
2010	10.52%	4.25%	12.62%	-2.10%	-0.27%	-1.71%	-8.37%	-5.67%	-6.67%
2011	-2.57%	6.25%	-2.18%	-0.38%	-1.23%	-1.28%	8.70%	8.13%	9.31%
2012	23.28%	23.43%	9.97%	13.31%	13.76%	9.76%	13.45%	14.38%	9.85%
Mean	12.53%	7.18	3.59%	8.94%	8.63%	8.25%	3.59%	4.87%	5.23%
Median	20.47%	8.27	9.97%	11.02%	10.34%	7.87%	3.60%	3.16%	6.99%
Minimum	-46.75%	-33.3	-28.33%	-18.42%	-10.99%	-3.34%	-14.02%	-8.82%	-7.67%
Maximum	38.34%	34.62	27.33%	40.32%	36.50%	38.00%	19.62%	19.76%	16.15%
No. of Positive Annual Returns	10	9	8	8	9	9	9	10	9
No. of Observations	13	13	13	13	13	13	13	13	13
Significance				10%	5%	5%	Not Significant	10%	5%
Tax & Transaction Adjusted Returns				6.61%			2.65%		

Table 1 - Annual Returns for the 'Dogs' Investment/Portfolio Selection Strategy.

This table reports the annual returns on the 'Dogs' investment strategy (R_{DOG}) calculated as the returns on an equally weighted portfolio of the ten highest yielding FTSE100 stocks. AR₁, AR₂ and AR₃ are described above.

Table 1 reports the annual 'Dogs' portfolio returns, market returns and the abnormal returns using the previously defined return measures AR₁– AR₃ for both the ten-stock portfolio drawn from the FTSE100 list and the FT30 list.

'FTSE 100' portfolio

In the ordinary sense of the word, both the mean and median market return are significantly larger than both the mean and median market return (R_{Market}) for this portfolio. Depending on the return measure used (AR₁– AR₃), the mean abnormal return ranges from 8.25% - 8.94% and produces positive abnormal returns in eight to nine years out of the 13 years examined. The significance of the main risk-adjusted returns are consistent in that the AR₂

and AR_3 abnormal returns are statistically significant at the 5% level in a two-tailed test. Of course, this inference is somewhat limited given that only 13 years returns are under consideration and, further, it must be borne in mind that these results are heavily influenced by 'outlier' results in 2000 and, to a degree, 2001. In particular, the result for 2000 is highly statistically significant and if this year is not considered, any statistical significance in the residual results largely evaporates and only AR_3 retains some significance (at the 10% level).

'FT30' portfolio

In contrast to the 'FTSE100 portfolio', both the mean and median portfolio returns (again in the ordinary sense of the word) are not significantly different than those of the market. The mean abnormal return ranges from 3.59% -5.23% and produces positive abnormal returns in nine to ten years. However, somewhat consistent with the 'FTSE100 portfolio', the AR_2 measure is significant at the 10% level while the AR_3 measure is significant at the 5% level. Again, it is interesting to note that these results are heavily influenced by stronger performance to this strategy from 2004-2006, without which, once again, the statistical significance of our results is largely absent for all abnormal return measures.

In order to ameliorate the effects of a relatively small data population used in our analysis, we turned our attention to monthly returns, reported in Table 2, for the portfolios drawn from both the FTSE100 and FT30 lists. The relative incidence of the number of positive monthly returns is low (in a range from 54%-58% of monthly observations) and, interestingly, none of the monthly risk adjusted abnormal return measures (AR_2 , AR_3) retain statistical significance in a two-tailed test and, overall, the results of an analysis of monthly returns clearly do not lend support to a 'Dogs' investment strategy.

	AR_2 FTSE100	AR_3 FTSE100	AR_2 FT30	AR_3 FT30
Mean	0.64%	0.70%	0.32%	0.43%
Median	0.49%	0.66%	0.41%	0.28%
Minimum	-14.01%	-9.72%	-17.99%	-10.47%
Maximum	15.68%	12.38%	25.52%	15.72%
Number of Positive Months	89	90	85	86
Significance	Not significant	Not significant	Not significant	Not significant

Table 2 - Monthly Risk-Adjusted Abnormal Returns for the 'Dogs' Investment/Portfolio Selection Strategy

This table reports the monthly abnormal returns on the 'Dogs' investment strategy (R_{DOG}) calculated as the returns on an equally weighted portfolio of the ten highest yielding FTSE100 and FT30 stocks. AR_2 and AR_3 are described above.

Tables 3 and 4 report the Sharpe and Treynor ratios for our FTSE100 and FT30 portfolios and the portfolio beta's. For the FTSE100 portfolio, Table 3 indicates that the 'Dogs' strategy dominated the market in only seven to nine out of 13 years. Similarly, Table 4 indicates that the 'Dogs' strategy dominated the market in ten years out of 13 for the FT30 portfolio – all of which is entirely consistent with the results presented in Table 1. The significance of the Sharpe and Treynor ratios (ie, the significance of the difference with equivalent ratios for the market) is, in the round, somewhat mixed and inconclusive and, in that regard, is consistent with the significance tests of the (annual) abnormal returns. Once again, when an analysis of the Sharpe and Treynor ratios is performed, excluding those ratio differentials for the afore mentioned 'outlier' years for the FTSE100 and FT30 portfolios, the statistical significance of the results all but evaporates and only the difference between the Treynor ratio for the 'FTSE 100' portfolio and the market retains any significance (at the 10% level). While the mean portfolio beta's (for both the 'FTSE100' and 'FT30' portfolios) are close to one (suggesting that the longer run systematic risk exposure of the portfolios is similar to that of the market), the above analysis of the excess risk-adjusted (abnormal) returns - particularly in the context of the clear implication of an analysis of monthly return data - and the scaled-for-risk returns (ie, the Sharpe and Treynor ratios), cannot be viewed as being supportive of a 'Dogs' investment strategy.

	FTSE100 Portfolio Sharpe Ratio	Market Sharpe Ratio	Sharpe Ratio 'Winner'	FTSE 100 Portfolio Treynor Ratio	Market Treynor Ratio	Treynor Ratio 'Winner'	Portfolio β
2000	0.405	-0.254	DOG	0.362	-0.139	DOG	0.729
2001	0.163	-0.385	DOG	0.120	-0.180	DOG	0.671
2002	-0.307	-0.381	DOG	-0.254	-0.261	DOG	1.184
2003	0.278	0.265	DOG	0.243	0.141	DOG	1.112
2004	0.565	0.298	DOG	0.198	0.085	DOG	0.836
2005	0.493	0.533	Market	0.279	0.163	DOG	0.989
2006	0.818	0.341	DOG	0.262	0.093	DOG	1.216
2007	-0.070	0.061	Market	-0.021	0.021	Market	1.109
2008	-0.639	-0.465	Market	-0.391	-0.296	Market	1.188
2009	0.338	0.389	Market	0.319	0.268	DOG	1.188
2010	0.209	0.214	Market	0.118	0.121	Market	0.849
2011	-0.134	-0.042	Market	-0.044	-0.026	Market	0.686
2012	0.433	0.271	DOG	0.240	0.085	DOG	0.953
Mean	0.196	0.065		0.109	0.005		0.978
Median	0.278	0.214		0.188	0.065		0.989
Minimum	-0.639	-0.465		-0.391	-0.296		0.671
Maximum	0.818	0.533		0.362	0.268		1.216
Significance		Not significant			Market	5%	
Summary Results:	'DOG' dominates 7 years	'DOG' dominates 6 years		'DOG' dominates 9 years	Market dominates 4 years		

Table 3 – Sharpe and Treynor Ratios for the 'Dogs' Investment Strategy (FTSE100 Portfolio)

This table reports the Sharpe and Treynor ratios for the 'FTSE100' portfolio and the market in years 2000-2012. The Sharpe ratios are calculated as the excess portfolio (market) return relative to portfolio (market) volatility. The Treynor ratios are calculated as the excess portfolio (market) return relative to portfolio (market) systematic risk. The significance reported is that of the difference between the mean Sharpe (Treynor) ratios of the portfolio relative to those of the market.

	FT30 Portfolio Sharpe Ratio	Market Sharpe Ratio	Sharpe Ratio 'Winner'	FT30 Portfolio Treynor Ratio	Market Treynor Ratio	Treynor Ratio 'Winner'	Portfolio β
2000	-0.090	-0.254	DOG	-0.111	-0.139	DOG	1.115
2001	-0.264	-0.385	DOG	-0.251	-0.180	Market	1.274
2002	-0.416	-0.381	Market	-0.231	-0.261	DOG	1.573
2003	0.266	0.265	DOG	0.164	0.141	DOG	1.082
2004	0.667	0.298	DOG	0.227	0.085	DOG	1.03
2005	0.910	0.533	DOG	0.350	0.163	DOG	0.818
2006	1.079	0.341	DOG	0.294	0.093	DOG	0.984
2007	0.075	0.061	DOG	0.039	0.021	DOG	0.754
2008	-0.462	-0.465	DOG	-0.400	-0.296	Market	1.223
2009	0.267	0.389	Market	0.278	0.268	DOG	1.223
2010	0.125	0.214	Market	0.048	0.121	Market	0.777
2011	0.116	-0.042	DOG	0.077	-0.026	DOG	0.787
2012	0.755	0.271	DOG	0.255	0.095	DOG	0.902
Mean	0.233	0.065		0.057	0.005		1.042
Median	0.125	0.214		0.077	0.065		1.030
Minimum	-0.462	-0.465		-0.400	-0.296		0.754
Maximum	1.079	0.533		0.350	0.268		1.573
Significance		5%			Market	10%	
Summary Results:	'DOG' dominates 10 years	Market dominates 3 years		'DOG' dominates 10 years	Market dominates 3 years		

Table 4 – Sharpe and Treynor Ratios for the 'Dogs' Investment Strategy (FT30 Portfolio)

This table reports the Sharpe and Treynor ratios for the 'FT30' portfolio and the market in years 2000-2012. The Sharpe ratios are calculated as the excess portfolio (market) return relative to portfolio (market) volatility. The Treynor ratios are calculated as the excess portfolio (market) return relative to portfolio (market) systematic risk. The significance reported is that of the difference between the mean Sharpe (Treynor) ratios of the portfolio relative to those of the market.

Taxes and transaction costs

A common subsequent criticism is that when subject to taxes and transaction costs, returns lose their statistical and economic significance. We have noted, in the round, very weak statistical significance with respect to our risk-adjusted abnormal return measures (ie, AR_2 and AR_3). We now turn our attention to an assessment of the economic significance of the excess portfolio returns.

Transaction costs

Transaction costs are inherently involved in replacing stocks which no longer meet the 'Dogs' criteria and in rebalancing the portfolio on each anniversary of its formation. We consider (i) the average number of stocks replaced

per annum and (ii) assume that of the stocks not requiring disposal, not all stocks will appreciate at the same rate and so there will be an element of partial disposal/acquisition so as to return the portfolio to one where the investment in the ten stocks is equally weighted. For simplicity we assume normally distributed long-run capital gains requiring half the balance of stocks (not disposed) to be rebalanced each year. Lastly, we assume a conservative transaction cost of 1%. This gives the following average annual return penalties for both the FTSE100 and FT30 portfolios:

FTSE100 Portfolio: [average annual stock turnover (54%) x transaction cost (1%)] + [half of the balance of stocks requiring rebalancing (46% x ½) x transaction cost (1%)] = 0.54% + 0.23% = 0.77%

FT30 Portfolio: [average annual stock turnover (33%) x transaction cost (1%)] + [half of the balance of stocks rebalanced (67% x ½) x transaction cost (1%)] = 0.33% + 0.335% = 0.67%

Taxes

For the 'Dogs' portfolios drawn from the FTSE100 list, the mean return ($R_{\text{DOGFTSE100}} = 12.53\%$, reported in Table 1) decomposes to a mean annual capital gain and dividend yield of 5.18% and 7.34%. Similarly, the mean return for the 'Dogs' portfolios drawn from the FT30 portfolios ($R_{\text{DOGFT30}} = 7.18\%$, reported in Table 1) decomposes to a mean annual capital gain and dividend yield of 1.83% and 5.35% respectively. For the first eight years of the period under study, the UK capital gains tax (CGT) rate was 40% and 28% for the remaining five years, which equates to an effective rate of CGT for the period of 35.38%. Throughout 2000-2012, the effective rate of UK income tax on dividend receipts was 25%. 'Dogs' portfolio investors would, therefore, suffer an effective return penalty (with respect to dividend receipts) of 1.84% (25% x 7.34% for the 'FTSE100' portfolio) or 1.34% (25% x 5.35% for the 'FT30' portfolio). Similarly, the (FTSE100 and FT30) 'Dogs' portfolio investor would suffer respective capital gain penalties of 0.99% (35.38% x 5.18% x 54%) and 0.21% (35.38% x 1.83% x 33%) in respect of stocks removed from the portfolios (sold) due to those stocks no longer meeting the qualifying criteria.

Taking all of the return penalties arising as a result of transaction costs and taxes produces total return penalties of 3.6% for the FTSE100 'Dogs' portfolio investor (0.77% + 1.84% + 0.99%) and 2.2% for the FT30 'Dogs' portfolio investor (0.67% + 1.34% + 0.21%). Given the mean annual gain on the market during this period (3.59%, reported in Table 1) and applying a similar average CGT rate would imply an 'index' investor should suffer a return penalty of 1.27% and the incremental return penalty for a FTSE100 and FT30 'Dogs' investors would be 2.29% (3.56% - 1.27%) and 0.93% (2.2% - 1.27%) respectively. When we consider the basic AR_1 measure for our portfolios and apply this incremental return penalty per annum, the mean return (AR_1) for the FTSE100 and FT30 portfolios is reduced to 6.61% and 2.65% respectively. Further, excluding the previously noted 'outlier' years for the 'FTSE100' and 'FT30' portfolios reduces the mean post tax and transaction excess returns for the residual years to 2.2% and -1.1% respectively.

In light of this analysis, we are left with the conclusion that our 'post tax and transaction cost' (AR_1) returns are effectively not significant for the 'FTSE100' portfolio (20% level) and not at all significant for the 'FT30' portfolio. Obviously an 'index' investor would not sell their units on an annual basis (although an individual 'portfolio' investor would have unavoidable income and capital gains tax penalties due to dividend receipts and necessary portfolio rebalancing) and so the return penalty may be even greater than that assumed for this analysis. In summation, consideration of tax and transaction costs implies that non-risk adjusted excess returns are not statistically significant nor, by extension, economically significant.

CONCLUSIONS

In this study we have examined the well-known 'Dogs of the Dow' investment strategy in the UK market from 2000-2012, applying the methodology to stocks drawn from the 'FTSE100' and 'FT30' lists. The results offer no substantial support for the notion that a 'Dogs' investment strategy may offer consistent investment potential in FTSE 100 or FT30 companies and suggest that, as an

investment strategy, any success is transient at best. Even if any risk-adjusted returns did persist, our analysis would suggest that post-tax and transaction cost residual returns are not statistically significant and we are left with the possibility that any residual excess returns may not be economically significant. These conclusions are consistent with those of McQueen, Shields and Thornley (1997), Domain, Louton and Mossman (1998), Hirschey (2000), Ap Gwilym, Seaton and Thomas (2005) and Rinne and Vahamma (2011). Our results are not wholly consistent with those of Filbeck and Visscher (1987) which suggested that a 'Dogs' strategy underperformed in the UK market. Consistent with the findings of Hirschey (2000) we find some evidence which points to periods where the 'Dogs' investment strategy produced poor relative performance.

Nevertheless, it is likely that, in the case of smaller individual investors with an appropriate attitude to risk, and for whom the cost of discretionary management advice would be either prohibitive or unacceptably diminishing to their investment returns, and for whom opportunities exist to shelter income and capital gains from relevant taxes, this investment strategy may, and no doubt will, continue to hold some degree of interest. This is all the more so in light of very poor returns available for smaller investors from currently available conventional products.

References cited in this paper are listed at cisi.org/rofmsept2014

THE TECHNOLOGY TRANSFER OF QUALITY FUNCTION DEPLOYMENT (QFD) FROM ENGINEERING INTO INVESTMENT MANAGEMENT

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ABSTRACT

Quality Function Deployment (QFD), originally developed as an engineering tool to translate vague design requirements into a detailed specification, was identified as a possible tool to translate unclear financial requirements of private clients into measurable targets. A visual matrix is used to translate these requirements using several tools to help set and rank targets.

This article sets out to investigate the transferability of QFD into investment management. It demonstrates an application of QFD to an investment management scenario, providing alternative methods to the current techniques. The results are encouraging. Potential benefits of applying this technique include an improved approach to identifying and meeting client suitability requirements.

INTRODUCTION

The financial industry has been plagued with problems of missold financial advice over the past few years. The Financial Conduct Authority (FCA) has introduced new rules on suitability to ensure clients are protected. The FCA is tasked with addressing the problems associated with providing financial advice, leaving companies exposed to new rules and regulations. Companies must have strict compliance measures in place to ensure the most suitable service is provided; however, clients' requirements may be vague and deciding the best option is not always clear cut.

Quality Function Deployment (QFD) is a method of ensuring quality, satisfying the customer by translating their vague requirements into measurable design targets (Akao, 1990). QFD was initially designed for engineering and has been successfully implemented by many companies including Ford,

Mazda and Toyota (Al-Mashari et al., 2005. ReVelle et al., 1998). Although originally intended for engineering, the technology was soon transferred to the service industry, with great success (Cohen, 1995).

The creator, Akao (1990), recognised that satisfied customers are one of the most important aspects to retaining business, QFD therefore focuses on identifying and understanding customer needs. Tools were developed to help achieve this, such as the House of Quality (HOQ). This article assesses whether investment management can benefit from QFD and, furthermore, what the effects are.

The author has undertaken this project as an opportunity was identified while working at an unnamed investment bank. It was noted that vague customer requirements were often given little consideration and generally were not translated into a meaningful specification.

For reasons of confidentiality, the bank that has provided details of its methods of investment management would like to remain anonymous. The bank is a global company that provides wealth management and financial planning to an array of clients and will be referred to as 'the investment bank' throughout the article.

Project aim and objectives

The aim of this paper is to investigate the transferability of QFD, used within the field of engineering, into the financial sector, with particular focus on investment management. This project will deliver a conclusion on whether QFD can be successfully applied to investment management as an alternative to the current techniques.

Methodology

To assess the feasibility of QFD in investment management, the concept should be applied to a real client. A client factsheet provided by the investment bank will be used to construct a HOQ.

Stuart et al. (2002) suggest five critical research stages. These stages will be followed accordingly and broken down to:

- Research question: Can QFD be successfully transferred, from engineering to investment management, benefiting the industry?
- Instrument development: Building a HOQ template and completing an example HOQ
- Data gathering: Using a client factsheet and an informal interview with the client to determine its exact requirements, these will be the input into the initial HOQ
- Data analysis: Determining the success of the implementation by gathering feedback from the investment bank
- Dissemination: Discussing the effects of QFD in investment management, advantages and disadvantages will be reviewed.

QUALITY FUNCTION DEPLOYMENT

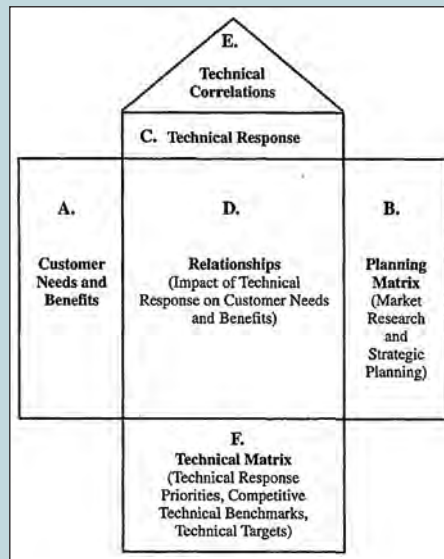


Figure 1- House of Quality (Cohen, 1995 p. 12)

QFD can be defined as a method of translating vague client requirements into detailed measurable design targets.

It works by cascading house of qualities (HOQ). The HOQ is a matrix used to identify and translate the client's requirements. Figure 1 shows the breakdown of the HOQ sections.

Section A - List of customer requirements. Also included is the importance's numbers. This is a numerical rating assigned to weight different requirements.

Section B - Competitor analysis of customer requirements; however after extensive research, was deemed too vague for investment banking purposes. This section has therefore not been used.

Section C - Responses to the customer requirements.

Section D - Matrix of relationships between customer requirements and technical responses.

Section E - Shows correlations between the technical responses to highlight any conflicting or reinforcing responses.

Section F - Results sections, including targets and overall importance calculated from the weights and matrix results.

Some of the response to the client's requirements can be very vague and cover a large area of expertise. For this reason it may be necessary to cascade the HOQ, as shown in Fig. 2, to identify further ways of addressing said requirement.

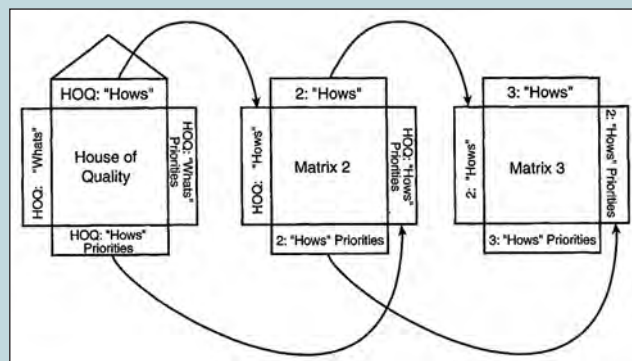


Figure 2- QFD implementation (Cohen, 1995 p. 14)

Cascading may be unnecessary as a single HOQ may contain all the information desired. There may be a chance of over-formulating the responses which should not be blindly followed; the HOQ should be used to actively encourage discussion. At this stage only a single HOQ has been drafted. Many of the construction steps can be automated to make the system as cost effective as possible, ideally with only specifics being entered manually.

The HOQ can be modified to include or exclude any parts as wished.

HOQ CONSTRUCTION

The following steps outline the construction steps of a HOQ with respect to investment management:

1. Gather relevant client requirements from client factsheet (possible automation). Establish further, more specific, client requirements from an informal interview. These requirements are then put into the HOQ under the Customer Requirements. Some of these requirements do not have to come directly from the client, for example regulatory requirements.

Importance Matrix		Urgency		
		High	Medium	Low
Importance	High	9	8	7
	Medium	6	5	4
	Low	3	2	1

Figure 3: Customer importance matrix

2. Assign a numerical weighting to each requirement, ideally this is carried out with the client. This can be done on any scale; however for the purposes of this, an importance/ urgency matrix was used as shown in Figure 3. This matrix can be easily explained to the client with relatively quick answers. How important, how urgent?
3. Note ways of translating the client's requirements into a specification to fill in the technical responses. The best way to do this is to go through the customer requirements individually and try to answer each one. This could also be semi-automated to fill in certain responses when certain client requirements are listed.
4. Complete correlations between the technical responses in the roof of the HOQ. These are, as stated earlier, responses to highlight any conflicting or reinforcing responses. This can be helpful when establishing solutions and targets. This section will have a + for positive, a - for negative, and blank for no correlation.
5. Complete HOQ relationships. This is the relationships between the client's requirements and the technical responses. A symbol relationship is used where • is given to a strong relationship, ° is given to a moderate relationship and a ∇ is given to a weak relationship, is given to a moderate relationship and a is given to a weak relationship. The matrix works by assigning numbers to the symbols, strong being the highest given a 9, moderate 3 and weak 1. There can also be no relationship where the cell is left blank.
6. Targets are filled out. These are ways in which the technical responses can be quantified by and how they will be achieved. These are also assigned an organisational difficulty. This is a rating of how hard it is for the company to achieve the target.

7. Finally a competitor assessment is filled out to evaluate how the company compares to other similar ones. This is helpful for identifying areas for improvement.

Figure 4 shows a HOQ that has been filled out with client data.

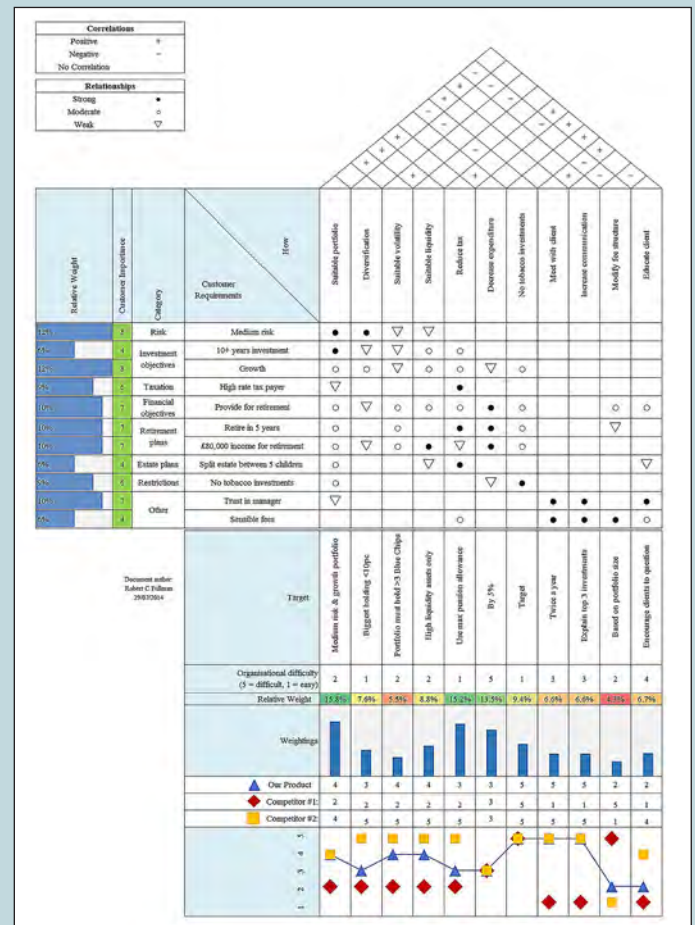


Figure 4 – Example client's HOQ

EVALUATION

To assess the suitability of QFD to match the client's requirements with investment services, a semi-structured interview was set up with a senior investment manager at the investment bank. The interview questions were designed to: assess if what was designed met the definition of QFD, if QFD had the potential to work in investment management, and finally; how, if at all, it could be further refined.

The first sets of questions were based on the ASI (1992) creative definitions of QFD and the second sets were to gauge the general impression of the investment manager on QFD.

In summary of the interview, eight out of the nine definitions were positively met. The only one not to meet the criteria was reducing uncertainty over the process, although it was admitted the tool may have potential for this.

Investment management is a particularly uncertain activity, where the skill of the manager is part of the service provided. Directly reducing uncertainty through the process is not probable; however, QFD can aid decision making which can lead to reducing uncertainty.

As well as the summary of the definitions, there were also relevant points raised. The main points of interest that were raised and general feedback received included:

- Testing and altering the model may be resource hungry
- Clients should not be involved in the interpretation of results
- More must be done to reduce model uncertainty
- Everyone must be aware of the tool
- Refinement of questions and categories to standardise the inputs
- It is a very good plan for a computer program/ algorithm
- The benefits of the roof of the HOQ were not seen.

All these points are valid and could be used in conjunction with further studies for improvements to the tool.

DISCUSSION

The approach to the design of QFD for use in investment management and the appropriateness of the tool are both of interest in examining QFD. The technology transfer of QFD must be assessed to decide on its suitability.

Approach to design

The design process started with first understanding the industry. It soon became apparent that the investment management industry had issues in translating customer requirements, some vague, into an actionable plan. When presented with a vague set of customer requirements in engineering that need to be translated into a design specification, QFD is one tool that can be used.

In identifying QFD as a method of transforming customer requirements into a detailed design specification, the possibility of transferring this tool into investment management was developed. The methodology to achieve the appropriate design first started with an initial HOQ and was refined through a combination of trial and error, general contact with a client who required financial advice and also a QFD academic. Once the initial design was completed, a semi-structured interview with a senior investment manager was set up to gather feedback.

To implement QFD, regardless of the type of industry, a HOQ template has to be constructed. This was initially identical to one that would be used in engineering. In filling in the matrix with gathered client data, the input data was too disorganised to have any structure to it which led to important requirements being easily missed. A solution to this was to categorise the input into classifications: risk, investment objectives, cash flow, liabilities, taxation, financial objectives, retirement plans, estate plans, restrictions and others. The HOQ was also modified to include categories for the technical responses, but these are likely to depend on the client and should be decided on at the discretion of the investment manager.

The next modification was the removal of the customer competitive matrix located on the right-hand side of the HOQ; although this works fine for engineering, the customer competitor assessment in investment management was not found to add any necessary value. It was important to keep the tool precise and ensure it was clear and concise, as it would be the first time QFD was being used and by inexperienced personnel.

The HOQ was also tidied up by hiding the working, non-value adding cells. As well as this, conditional formatting was added to the percentage results to clearly highlight which responses were of highest importance. The product/technical response comparison was reformatted by only including a joining line on 'our product' to highlight the company's comparative performance.

Once the HOQ was completed, a report was sent off to the investment bank which included a completed HOQ and template. The feedback questions were based on QFD definitions.

Technology transfer

With the aim to investigate the transferability of QFD, used within the field of engineering, into investment management, it is important to assess the differences between QFD used in engineering and in investment management.

The main differences between the two applications are the technical responses. Engineering responses are easily made quantifiable whereas in investment management this is not so simple: they may be qualitative or quantitative. These potential qualitative outcomes, for example suitable liquidity, are hard to quantify and generally rely on the investment manager's experience. This was noted by the investment manager on the feedback, suggesting the use of a numerical scale to all outcomes. For example a scale of 1 to 10 could be used and when certain targets use 'medium' then a 5 could be used. This at least allows a standardised set of outcomes for comparisons and relies less on judgment of what 'medium' means.

The other difference between the two industries is cultural. In engineering, QFD and other quality related ideas are widely accepted because of their known success. This makes implementation much easier as acceptance is much higher. In finance, QFD is a relatively unknown technique which people may not easily accept. Acceptance may be difficult with the more experienced managers who believe they know best and may oppose any changes to their methods. It must be viewed, and presented, as a tool they work with rather than a framework to constrict them.

As Johnson and Lybecker (2009) discussed, acceptance is important in a successful technology transfer. Ongoing support and assistance must be provided to aid the implementation. These are both aspects that must be considered to assess if the technology transfer would achieve the set out goal; furthermore, the tool must be checked by the internal compliance department of an investment bank, before use, to ensure it meets regulatory standards.

Appropriateness of tool

From the feedback gathered, the results of which QFD definitions were met can be answered. Out of the ASI's (1992) nine creative definitions of QFD, seven had positive results, one had potential and one was not met at all. The only definition not met was reducing uncertainty over the process, a very difficult task, as investment management is inherently uncertain. It can be concluded that this is not the fault of the tool but that of the industry which cannot be avoided.

Benefits

The benefits of QFD are numerous. The main benefit that it is a customer determined process, allowing the customer to identify exactly what they want, giving them an input into the design of, in this instance, the service.

QFD aids communications, both between the client and investment manager and internally in the company. It can be used effectively as a tool to encourage active discussion between other managers, departments and client. This discussion encourages questioning of every process. QFD is a very good planning tool. This allows the company, once the customer requirements and solutions are identified, to plan a suitable method of implementation. Process efficiency can also be improved as QFD lists weightings alongside targets and organisational difficulty. This can aid ordering of targets by importance and ease. Other benefits include: competitive analysis, reduced development time and cost and, documentation of the process of matching customer requirements to solutions and targets. Documentation is proving more important than ever before with increased regulation since the 2008 banking crisis.

Finally it must be noted that QFD is a unique tool. It could provide certain marketing advantages, perhaps not to retail clients, but to institutional investors who may have more knowledge of the investment process and who may understand the tool better. This provides the bank using the tool a potential selling point.

Issues

The feedback gathered was invaluable; however, only one semi-structured interview was conducted. This is satisfactory for initial findings, but to obtain a more accurate and reliable set of opinions and data, a sampling method as discussed by Das (2009) should be undertaken.

Retrospectively, the relative weighting in the results section of the HOQ should have taken into account organisation difficulty in the calculation. By using Pareto analysis principles, the most significant and easiest task could be allocated a higher weighting and therefore help produce an order of task by importance and ease.

Other issues included construction time. Creating the HOQ was a very time intensive process, although some automation could significantly improve this. Increased time can increase cost, which should be outweighed by the cost benefits brought by QFD.

CONCLUSION

The aim of this paper was to investigate the transferability of QFD, used within the field of engineering, into investment management and answer whether QFD can be successfully applied as an alternative to the current techniques. By applying a client's requirements to a HOQ and receiving successful feedback, a HOQ has successfully been implemented. It is still not clear whether QFD is suitable as a tool, as it was found that the success of the HOQ resulted in the lack of need for cascading into a full QFD. Feedback also suggested that the submitted HOQ met eight out of the nine ASI (1992) creative definitions of QFD, with uncertainty not being reduced. From this it can be concluded that the method was QFD with a majority of definitions met. The objectives: applying a HOQ to investment management, assessing the suitability of QFD to match the client's requirements with investment services and evaluating the effectiveness of the technology transfer of QFD were all met successfully.

The technology transfer did present some initial problems, such as the extreme differences between engineering and finance. Some of these, such as culture, are hard to assess until further testing and gathering of feedback is completed. Ongoing support and assistance must be considered, as well as the legal and regulatory challenges that may be faced. It is critical that there is sufficient knowledge of the tool for successful implementation.

Further development should start with increasing the sample size. This would improve the accuracy and reliability of data. An increase in feedback would also help refine the tool further for application in investment management. Automation of certain parts of the HOQ could potentially lead to strong interest from investment banks as discussed in the interview. Finally, applications beyond what has been discussed here in this paper may be explored prompted by the technology transfer of QFD.

To conclude, it does appear that QFD has potential for successful application to investment management in the future. Further work is required to add validity to the findings presented in this paper; however, the initial findings suggest there could be a positive outcome.

References cited in this paper are listed at cisi.org/rofmsept2014

GOVERNANCE, CONDUCT COSTS AND EQUITY PERFORMANCE IN FINANCIAL SERVICES: RECENT EVIDENCE OF LARGE FINANCIAL INSTITUTIONS

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ABSTRACT

Studies correlating corporate governance and equity values of publicly-listed banks yield varied conclusions, depending on geography, business cycles, and other factors. Few have examined financial services in mature (yet volatile) markets, specifically around conduct costs as a corporate governance indicator - the purpose of this preliminary study. Conduct costs are monetary fines or redress demanded by regulators and legislators, publicly reported by institutions. Despite recent events, clear correlation of these costs with equity value is not obvious. Banks' role in the financial crisis begs further scrutiny of this dynamic, which theory suggests should be negative (high conduct costs lower returns, and thus shareholder value). Lower costs, reflecting stronger governance, lead to superior returns - the initial result of this study of ten banks over the last six years. High conduct costs have negative impact, albeit small, on returns and value. This further reinforces the expected benefits of proper governance to shareholders, managers, regulators and all stakeholders in financial services.

BACKGROUND

Internal determinants of company equity value have been the subject of numerous studies, which have yielded insights into important factors such as profitability, solvency and asset quality. Internal determinants are factors influenced by a bank's management decisions. Although good quality management is seen to lead to good performance, it is difficult, if not impossible, to assess management quality directly. It is explicitly assumed that such quality will be reflected in operating performance. As such, it is not uncommon to examine a bank's performance in terms of financial variables found in financial statements.

Features of corporate governance, another internal determinant, have also been identified as additional influences on firm value (Adams and Mehran, 2008; Agoraki et al., 2009). Corporate governance encompasses a wide range of mechanisms intended to mitigate agency problems, by limiting opportunistic behaviour of management (Ashbaugh et al., 2004). Prior studies have examined indicators such as board composition, board and executive compensation, and internal audit quality, largely indicating that good corporate governance does have a positive impact on firm value. Another primary governance indicator, not yet examined in detail, is that represented by conduct costs, the money that banks and other firms pay out in the form of fines or redress levied by regulators and legislators. These costs may also include other forms of payments, such as sums paid in settlement of either regulatory proceedings or litigation based on allegation of a firm's misconduct. Amounts paid for the repurchase of securities from the market at the behest of regulators, eg, because they were missold, are also included. Therefore, practices such as misselling of payment protection insurance (PPI), benchmark manipulation and breaching of money laundering rules all fall under the definition of conduct costs (McCormick, 2014). Many large banks have set aside meaningful provisions for these costs in recent years.

This paper investigates the extent to which conduct costs, effectively a failure of corporate governance, affect market return and value among a group of ten large banks over the past six years (2008-2013), for which data are readily available. Conduct costs are measured by reported annual penalties paid by banks up to the end of 2013, as well as provisions made at the end of 2012 and 2013. Data preceding 2008 remain sketchy, hence the focus on the last six years, which also coincides with the financial crisis, when external determinants such as GDP, not included in this study, played

a significant role. The prediction is that the level of annual conduct costs, as a percentage of pre-tax income, is negatively related to banks' equity returns (ie, higher conduct costs result in lower returns). Conduct costs by their scale and uncertainty represent a risk to shareholders, resulting in an erosion of value (Garmaise and Liu, 2005). If, on the other hand, higher conduct costs are associated with higher returns, perhaps through benefits of greater transparency, or have no discernible impact, another explanation for this relationship is to be sought.

It should be noted that conduct costs recorded up to now for ten big banks, even on a cumulative basis since 2008, still account for a small proportion of the banks' total assets (from 0.3% to over 5%), but an increasing percentage of their market capitalisation (from 4% up to 36% for the ten banks, including year-end 2013 provisions). The effect of conduct costs could become more meaningful over time, given current trends.

Since conduct costs are only one factor affecting value, and potentially small at that, it is appropriate to consider another important factor driving value. Evidence indicates that investors are focused on risk and profitability expectations (European Central Bank, 2010), therefore a key parameter is a risk metric such as levels of impaired assets. The prediction is that returns and value should be positively correlated with good asset quality, as measured by impaired loans to gross loans.

Why is this preliminary study important? Surveys in the UK (Which?, 2012) and US (Edelman, 2014) continue to show that banking is one of the professions least trusted by the general public, a view which regulators and other participants are striving to address (Lambert, 2014). There is evidence that, while the first priority of stakeholders in a company is the quality of the company's products or services, the second is the trust and confidence that stakeholders have in the company (Phillips, 2004).

The purpose of finance is to assist people in saving, managing and raising money. Economic globalisation has increased the magnitude of finance to systemic importance, counterbalanced by conduct costs for ten banks alone exceeding £150 billion over a five-year period, well above the UK National Health Service's annual budget, for example (McCormick, 2014). It is therefore critical to re-build trust in the industry, which involves reinforcing with all stakeholders the importance of good governance, and emphasising corporate and social responsibility (CSR). Institutions pay a price for misconduct, not only in quantifiable monetary terms, but also in less tangible costs to reputation and franchise.

Good governance and conduct (measured by relative level of conduct costs) should correlate positively with long-term investment performance (measured by annual equity returns over six years), given that a firm's culture and ultimately value is strongly influenced by the nature and quality of leadership shown by the board and executive management.

LITERATURE REVIEW

Much previous research has been done on the relationship between corporate governance indicators of publicly-listed companies and their returns and value. A landmark study was made by Gompers et al. (2003), who looked at a wide sample of European companies over a multi-year period, using a large number of governance criteria. This concluded that good governance, in fact, resulted in higher value, a finding further reinforced by Bauer and Gunster (2003), although the latter found that this did not always hold in the short term.

Looking specifically at the UK, Shaikat and Padgett (2005) determined that an index of non-compliance with the UK Code of Corporate Governance for a panel of FTSE350 companies over a four-year period was negatively related to total shareholder return, implying that more compliant firms have higher returns. On a wider basis, McMurrian and Matulich (2006) concluded that demonstration of business ethics added value for customers and heightened firm performance and profitability. More recently, Abdullah and Page (2009) examined UK non-financial companies, revealing no strong systematic relationship. A similar conclusion was reached by Diavatopoulos and Fodor (2010). Marsat and Williams (2011) actually observed strong evidence of

a negative impact of responsible behaviour on corporate market value. Giroud and Mueller (2011), however, found positive correlations between good governance and good market performance, particularly in non-competitive industries, while Lewellen (2012) saw no compelling industry-specific governance factors to explain differences in returns. Huppe (2011) concluded that so-called CSR 'alpha' resulted largely from the improved disclosure entailed in implementing CSR. Mouselli et al. (2014) pointed to audit quality as an important governance determinant, recently echoed by CFA Institute (2014). Most recently, scholars associated with the London School of Economics (LSE: McCormick, 2014) have compiled total conduct costs for ten large US, UK and European banks, in terms of total costs incurred 2008-2013 (also along with provisions made for the same as of 31 December, 2012 and 31 December, 2013, as reported on their balance sheets). While this study did not draw any relationships with equity performance, this is seen as a useful next step.

Casson (2013) finds that explicit reference to principles of proper conduct is largely absent from governance guidance and regulation in the EU. It seems that a solid link is yet to be made that what constitutes proper conduct, reflected in good governance, is good for business, and hence shareholder returns, or that what is improper is negative for returns and value.

High conduct costs ultimately affect the profitability and capital positions of banks (the UK regulator has warned of this recently: Finch, 2014), but the actual extent to which this is observed has polarised opinion. There are admittedly limitations to the use of conduct cost data. For one thing, they are based on figures solely in the public domain which in some cases includes 'incomplete information.' Hence all data must be regarded as approximate. Initiatives towards establishing a more consistent approach to disclosure of material information in this respect are to be welcomed.

Further, some have argued that a political agenda lies behind the scale of the reported conduct costs, which are not solely driven by bank managements themselves. J.P. Morgan, for instance, stated that 80% of the misconduct covered by its \$13 billion settlement for toxic mortgage-backed securities stemmed from Bear Stearns and Washington Mutual, both taken over by Morgan in 2008. Given the bank's strong market position, some commentators claim it was pressured by the US Government to acquire troubled banks in order to help stabilise the US economy (Benedict, 2014). In this regard, greater transparency is also to be expected of governments and regulators in their actions.

As also pointed out by Benedict (2014), this cost analysis highlights different reporting and regulatory standards across different jurisdictions, which potentially emphasise deficiencies in national corporate accountability and transparency. One of the purposes here is to analyse firm-specific, rather than jurisdictional, failings with the ultimate goal of encouraging healthy competition among banks from a stakeholder perspective. For instance, the study excludes banks domiciled in the Asia-Pacific region, and Canada, where conduct costs tend either not to be reported or not incurred. The extension of the LSE project to more banks around the world, currently under way, is a welcome initiative.

Some have observed a drag on asset value associated with conduct risk (Worship et al., 2013), based on shorter-term market movements. There is often a price decline associated with a large liability, but sometimes also a price increase due to greater investor certainty going forward. Other analysts have noted a 'multiplier effect' of conduct costs on bank valuations greater than that associated with 'normal' trading losses (Moynihan et al., 2013). Decreases in market capitalisation relating to conduct losses have been observed to be typically 2-8x greater than the size of the underlying loss event. Of greater interest perhaps are the longer-term effects of elevated conduct costs on profit and market value.

HYPOTHESIS AND RESEARCH METHODOLOGY

To help rebuild trust in the financial system, it is important to better align the interests of managers and stakeholders, a primary group being shareholders in financial institutions. If it is observed that well-governed companies

provide superior value, by not incurring excessive conduct costs, this can send a strong message to boards and managements that good governance contributes to enhanced wealth creation, thus providing further incentive to strengthen and maintain good governance and conduct. This should drive greater transparency, management accountability and responsibility, and ultimately greater trust in institutions from investors and the general public, who are the customers of these institutions. The objective of this research is to show a link between measures of corporate governance and misconduct in large financial companies and their returns over a multi-year period. The research plan involved examination of market returns of a sample of large financial institutions over the past six years (2008-2013), contrasting that with conduct costs paid as publicly reported by these companies, and as analysed by others.

As stated, conduct costs relate to money that banks have paid out in the form of regulatory fines or redress demanded by regulators. They may also include other forms of payments, such as:

- Sums paid in settlement of regulatory proceedings (whether or not there is any admission of wrongdoing)
- Sums paid in settlement, or at the conclusion, of litigation that is based on an allegation of a bank's misconduct or that of its officers (although it is not intended to cover all litigation costs, whatever the nature of the claim)
- Sums paid for the repurchase of securities from the market (because they were missold) at the behest of regulators
- Egregious losses caused by a bank employee's serious misconduct and/or attributable to poor risk management.

Therefore, practices such as misselling of PPI, benchmark manipulation and breaching money laundering rules fall under the definition of conduct costs (McCormick, 2014).

These recorded conduct costs, as one independent variable, are then compared against the historic market returns of the banks, in order to gauge their effect on returns. Given the relatively small sample of ten banks, a cross-sectional panel regression approach is used, incorporating other variables. Return information is correlated against actual conduct costs paid, as a percentage of pre-tax income, along with a proxy for asset quality, which is the reported level of impaired loans as a percentage of gross loans.

Panel data are commonly used because of the following reasons. First, this has the advantage of giving more informative data as it consists of both the cross-sectional information, which captures individual variability, and the time series information, which captures dynamic adjustment. In short, panel modelling helps identify a common group of characteristics while, at the same time, taking account of the heterogeneity that is present among individual units.

The consensus from the literature is that the appropriate functional form of analysis is the linear one. Thus in this study a linear model is used to analyse the cross-section time series data to isolate the equity performance determinants of the banks.

Panel data models are usually estimated using either fixed-effect or random-effect techniques. If the number of time series data (T) is large and the number of cross-sectional units (N) is small, there is likely to be little difference in the values of the parameters estimated by the two models. Since there are only ten cross-sectional units that involve six years' data in this study, the regressions in our study are estimated by the fixed-effect model.

Conduct cost metrics focus on actual costs incurred and paid per year, as a percentage of pre-tax income earned in that year. These data are compared with asset quality of the firms (using Bankscope as an information source), in order to correlate conduct costs with historical returns, largely following the methodology of previous related studies (Cordeiro and Vilayath, 2003). Such an investigation ultimately lends itself to wider samples and longer time periods, but initial indications may suggest that equity investors are rewarded by good governance, as manifested in lower relative conduct costs, which help them to make positive investment decisions based on

transparency, robust risk management and service to stakeholders.

HYPOTHESIS

This study considers whether the following deductive hypothesis, constructed based on the literature review – after Garmaise and Liu (2005) and Peni and Valhalmáa (2012) – can be applied to banks, and thus can result in recommendations for future research.

H1: that banks incurring high conduct costs as a percentage of their pre-tax income exhibit lower market returns on average, and lower valuations, due to the consequences of inadequate governance.

RESEARCH METHODOLOGY

The author conducted a quantitative approach of deductive reasoning to the hypothesis, employing a secondary quantitative statistical analysis of data following prior research methods.

BANK FEATURES

The sample of ten banks include four based in the UK, four in the US, one in Switzerland, and one in Spain. All have had meaningful operations in the UK over the period of the observation. All rank among the world's 30 largest banks by market capitalisation, and among the top 15 in the US and Europe by the same measure. All have a presence on the London Stock Exchange.

DATA ANALYSIS AND DISCUSSION

The hypothesis was tested using pooled time-series cross-sectional regression analysis. This procedure deals with data sets that consist of time series observations (in this case the six years from 2008-2013 inclusive) on each of several cross-sectional units (in this case, the ten banks). The pooled time-series cross-sectional regression (implemented using the regression function in Excel) uses a general model of the form:

$$1. \text{Returns} = f(\text{conduct costs/pt income, impaired/gross loans})$$

The basic regression equation is as follows:

$$2. \text{Returns} = \alpha + \beta_1 \text{conduct_cost/pretax_income} + \beta_2 \text{impaired_loans/gross_loans} + \epsilon$$

Equity market return is the dependent variable, the independent ones being relative level of conduct costs (to pre-tax income), and impaired loans to gross loans.

The empirical evidence on the determinants of bank's equity returns is based on balanced panel data, where all the variables are observed for each cross-section and each time period. In this study, a single econometric specification is estimated, including only the bank-specific variables. The estimations are performed by the generalised least squares (GLS) technique, especially suitable for data sets where serial correlation and/or heteroscedasticity might be present.

The results of the regression analysis are given in table 1.

Bank characteristics	Predicted sign	
Intercept	?	0.060177 (0.09699)
Conduct costs/pre-tax income	–	-0.02515** (0.013625)
Impaired loans/gross loans	–	-10.7881** (5.04957)
R squared	–	0.12
No. of observations		60

(i) The regression is based on fixed-effect estimation and is estimated using GLS estimation pooling bank level data across ten banks for the 2008-2013 period.

(ii) Standard errors are given in parentheses. ** indicates significance at the 0.05 level or better.

DATA ANALYSIS AND DISCUSSION

H1: that banks incurring high conduct costs as a percentage of their pre-provision income exhibit lower equity returns on average, and lower valuations, due to the consequences of inadequate governance.

R2 shows how well this combination of variables can predict market returns, and in this sample R2 at 0.12 shows that 12% of the variation in returns is attributable to the variables of conduct costs to pre-tax income and impaired to gross loans, thus suggesting that other elements may play a larger part in predicting overall returns.

However, as indicated in Table 1, the negative coefficient of conduct costs indicates better returns for well-governed banks, which result in lower costs of conduct.

The inverse relationship also between returns and impaired to gross loans supports earlier findings (Staikouras and Wood, 2003) that asset impairments reduce the market return and value of banks. Though banks tend to be more profitable when they are able to undertake more lending activities, yet due to the credit quality of lending portfolios, a higher level of impairments occurs. Such a high level in fact depresses banks' equity returns significantly.

The analysis has yielded a couple of key findings. First, a negative association is observed between conduct costs as a proportion of pre-tax income and the sample banks' equity market performance. Second, it is documented that conduct costs relative to pre-tax profit have some limited explanatory power for banks' equity returns after controlling for the risk proxy of asset quality. The observation that banks with relatively low conduct costs have superior equity returns adds to the literature on the financial information characteristics valued by the market. This result also provides insight into how governance is priced in that it is observed that conduct costs and asset risk are partial determinants of firm value. These findings lend support to Garmaise and Liu (2005), who model firms' exposure to risks as a function of the quality of firms' governance.

LIMITATIONS OF THE STUDY

The scope of this short paper limits consideration of the many variables that can contribute to differing outcomes, but the author has statistically considered the variable of asset quality in addition to conduct costs to deepen results. The literature review has been limited to post-2003 studies and has also not considered external determinants of bank returns, which during the sample period could have a significant effect.

The author has presupposed that the banks considered have similar characteristics. Results from previous literature indicate that a variation of results may be dependent on study size.

Due to length restrictions and data availability considerations, basic regression analysis has been undertaken, although more complex statistical analysis may have produced different results.

SUMMARY AND CONCLUSIONS

This paper explored the link between bank conduct costs, a key governance indicator, and their equity returns. High conduct costs can affect equity returns through their impact on profitability and capitalisation of the bank. Promoting high standards of conduct and reducing conduct costs enhances profitability and capital, and provides management with a transparent long-term planning horizon. All of these are perceived positively by shareholders, resulting in enhanced equity performance.

These arguments were tested on ten large international banks over the period 2008-2013, measuring reported conduct costs as a percentage of pre-tax income against market returns over that timeframe. The results suggest that returns are negatively associated with conduct costs, in other words, that banks incurring high conduct costs yield lower equity returns relative to their peer group.

A contribution is made to the existing literature on the determinants of value and return by identifying another factor that explains value and return beyond factors traditionally used to explain them. Consistent with prior research on costs (Staikouras and Wood, 2003), it is documented that the level of conduct costs is negatively related to banks' equity performance.

There are several potential directions of future research that this study would suggest. One direction is to study the effect of conduct costs on other cost of capital measures, such as the cost of debt capital. Another potential extension is to use more refined measures of conduct costs and to study their effect on overall cost of capital. This line of research would help to develop a clearer picture of the relative benefits of lower conduct costs, since ultimately one of the primary reasons for the existence of effective governance mechanisms is reduction in the cost of capital.

References cited in this paper are listed at cisi.org/rofmsept2014

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Claire's monster challenge

THERE IS ONE SIGHTING GUARANTEED IN THE WATERS OF LOCH NESS THIS MONTH – THAT OF CLAIRE BENNISON, CHARTERED MCSI, AS SHE ATTEMPTS TO SWIM ITS 23-MILE LENGTH

◆ LORA BENSON

Claire Bennison will take the plunge into the Scottish waterway on 19 September for a gruelling swim that could take as long as 20 hours, depending on the conditions.

Such a challenge is nothing new to Claire. Her swimming exploits have included crossing the English Channel and every other major lake in England, Scotland and Wales. But even with that track record, Claire, who lives in Saddleworth near Manchester and is Regional Director for Brooks Macdonald Asset Management in the North, knows Loch Ness will be a tough nut to crack.

“To my knowledge, only ten or 11 individuals have ever completed this challenge,” she says. “The biggest difficulty is not the distance – I’ve swum further – but the low temperature of the water due to the depth of the Loch. The temperature will fluctuate between six and 12 degrees centigrade, and that brings with it the risk of hypothermia.”

Claire will not even have the protection of a wetsuit, as competing in a standard costume

is required for the swim to be officially recognised. She will rely heavily on a support boat to complete the swim in safety. The support team will supply her with energy

“It was a very special 80 hours and something that will stay with me for a very long time”

drinks and supplements that will be passed to Claire in a baby bottle attached to the end of a pole, as she is not allowed to touch the boat. Spotters on the boat will keep track of Claire’s stroke rate and regularly ask her simple questions, gauging her responses.

She says: “If there is cause for concern that hypothermia may be setting in – if I suddenly, say, drop from 56 to 40 strokes a minute, or struggle to remember an easy fact – they will pull me out of the water.”

Claire’s passion for open-water swimming dates back to 2009, when she took on the cross-Channel challenge in aid of charity, reaching France in 16hrs 40mins. “It was a big decision to take part, as I had not swum seriously for around 20 years. I essentially had to learn to swim all over again.”

Amazingly, that gruelling feat does not even top Claire’s list of her achievements. Her most treasured memory is of completing the ‘Super Six’ – swimming the three biggest lakes by water surface in the UK and conquering Britain’s three highest peaks.

In an endurance challenge lasting more than three days, she swam 38 miles, taking in Loch Lomond in Scotland, Windermere

in England (pictured) and Bale in Wales, and walked more than 10,000ft to scale Ben Nevis, Scafell Pike and Snowdon. “The only rest between swimming each lake and walking the corresponding mountain was the drive between them,” she says. “It was a very special 80 hours and something that will stay with me for a very long time. I’m the only person to have completed the Super Six solo.”

Through her swimming, Claire has helped worthy causes. She has raised thousands of pounds to support the care of a friend diagnosed with multiple sclerosis. Claire has also raised about £15,000 for the Nema Foundation, which supports more than 20 villages in an impoverished area of Mozambique. “I became involved after seeing the conditions in the villages during a diving holiday. The generosity of many people, including the Brooks Macdonald Foundation, has enabled me to raise enough money to make a real difference.”

Do you combine your day job with an unusual activity or hobby?

Over the past six years, we have featured articles about some amazing CISI members in the *Securities & Investment Review* and we are looking for more.

Profiles have included a boxing second, an ex-Olympic cyclist, an ice climber, a watchmaker, a soldier who served in Afghanistan, a martial arts expert, a photographer of celebrities and a sky diver.

➤ Contact lora.benson@cisi.org if you have a story you think will interest other CISI members. You will get a £25 shopping voucher as a ‘thank you’ if we publish it.



THANKS TO CLAIRE, THESE CHILDREN CAN ATTEND SCHOOL IN MOZAMBIQUE

Pile of problems

A JUNIOR MANAGER FACES A TOUGH DECISION WHEN HIS BOSS PRESSURES HIM TO BEND THE RULES TO SPEED UP THE COMPLETION OF A REPORT. HOW SHOULD HE HANDLE THE SITUATION?



Satish is an ambitious junior manager in the settlements team of a major international bank. The company went through a difficult period a number of years ago when it struggled to keep up with a greatly increased flow of daily transactions, which led to criticism by the regulator at the time.

More employees were hired and a commitment was given to the regulator that appropriate processes would be put in place to monitor performance in the affected area. This resulted in the introduction of an internal reporting system that is now viewed as increasingly onerous and somewhat irrelevant by those who were not involved in the company's earlier problems.

As a result, the requirement that reports are signed by nominated position holders is not always followed to the letter. Approaching a year-end, Satish is asked

Satish is beginning to feel under some pressure but, believing that he is in line for promotion, is determined to meet all his deadlines

by Eamonn, his manager, to ensure that the departmental management information, which Satish co-ordinates and analyses, is up to date for discussion at the next

heads-of-division meeting. Eamonn will be the focus of attention at the meeting, bearing in mind the previous and well-documented difficulties of his team. The meeting is to take place off-site and Eamonn will have to fly out the previous day.

Satish is beginning to feel under some pressure but, believing that he is in line for promotion, is determined to meet all his deadlines, conscious that his chances of moving up the career ladder will be influenced by how well he performs at times like this. Consequently, he comes into work early and stays late to ensure that he can keep on top of his daily routine, as well as meet Eamonn's needs.

Sounding exasperated, Eamonn says he is too busy preparing for the heads-of-division meeting to be concerned about signing off on the regulatory report

As the end of the reporting period approaches, Eamonn is anxious to get the figures as early as possible. He begins to press Satish for them. At the same time, Satish is reminded by the firm's regulatory reporting unit that his department's regulatory report is also due, and that it needs to be signed off by Eamonn as head of department. This is a requirement of the company's operating procedures, which were introduced as a result of the commitment given to the regulator.

THE FIRM'S PROCEDURES

As his deadlines loom, Satish provides Eamonn with his management information and takes the opportunity to remind him that he will also need to sign off on the regulatory report, which will be ready the next day. Sounding exasperated, Eamonn says that he is much too busy preparing for the heads-of-division meeting to be concerned about "that sort of stuff" and suggests to Satish that if he is confident the report is correct, he should sign it off on Eamonn's behalf. Satish is aware of the firm's procedures,

but does not feel able to say anything to Eamonn at this particularly stressful time and is relieved simply to have completed the management information.

The next day, the regulatory report is completed and given to Satish for him to get Eamonn's signature. In light of Eamonn's comments, Satish tells his colleague to leave the report with him and he will see whether he can get Eamonn to sign it. However, Eamonn, who is getting ready to leave for the airport, is very busy.

Satish waits until Eamonn appears to be free and goes into his office with the report, which he asks him to sign.

"I told you that you could sign it," says Eamonn as he heads for the door after gathering up his papers and bag. "It is only a report and you know what it is all about. You have my complete confidence."

IN BREACH OF COMPANY RULES

Satish is torn between signing the report, which his boss has told him to do, and complying with the bank's procedures. He wonders what he should do and considers the various options:

- If he signs the report for Eamonn, he will keep his boss happy, but he will be in breach of company rules.
- If he does not sign the report and waits for Eamonn to return, the report will be late and the department will look bad again, which may affect his chances of promotion.
- As Eamonn has told Satish to sign the report, surely he can safely do so?
- Perhaps he should tell the regulatory reporting unit what happened regarding Eamonn's missing signature and explain that Eamonn had 'authorised' him to sign the report?

What would you advise Satish to do?

Visit cisi.org/problems and let us know your favoured option. The results of this survey and the opinion of the CISI will be published in a future edition of the *S&I*.

A PUFF OF SMOKE: THE VERDICT

The 'Grey Matters' dilemma in the June 2014 print edition asked readers to consider the situation in which a firm was seeking to recruit a new member of staff and was faced with selecting from two distinctly different candidates. The charismatic Emma was the preferred choice despite the other candidate, Thomas, having more relevant experience.

The preferred candidate reveals that she had received a cannabis warning from the police a number of years earlier, and the question was asked what impact, if any, the revelation should have on the hiring decision.

The great majority (78%) of respondents supported hiring Emma, the revelation notwithstanding, and many then commented on why they had done so. Generally, it was felt to be in Emma's favour that she had revealed something that she did not have to reveal.

Most respondents accepted that preferring a female recruit in order to meet the firm's diversity objective is a legitimate aim, provided that she meets the technical requirements of the job, and that this is a situation that occurs in all walks of life.

The Institute's view is that Emma's cannabis warning does not provide a good enough reason not to hire her, given that she is believed to meet all the other requirements of the position. A cannabis warning is not a criminal offence and is not recordable, so is not something that would have been revealed in a wider check. The fact that Emma owned up to this indiscretion may be viewed as a positive demonstration of her honesty, and the action itself as a youthful indiscretion that should not affect the rest of her life.

IT MEANS MANY THINGS TO MANY PEOPLE, BUT FOR ALL THE HYPE, WHAT IS BIG DATA? A MAJOR NEW STUDY HAS SHED SOME LIGHT ON THE SUBJECT

Big data

and why it matters

According to the distinguished economist John Kay: “Short-term weather forecasting is one of the triumphs, perhaps the greatest triumph, of big data – the opportunity supercomputers provide to process data sets of unbelievable size and complexity.” He was comparing the largely accurate hourly forecasts today with Michael Fish’s horribly wrong assertion on primetime British TV in 1987 that rumours of an imminent hurricane were unfounded.

Hard facts about big data are surprisingly tricky to come by. One of the biggest studies to date was conducted by IBM and the Saïd Business School at Oxford University, surveying 1,144 business and IT professionals in 95 countries, including 124 respondents from the banking and financial markets industries, who represented 11% of the global respondent pool.

Keith Bear, IBM’s Director of Financial Markets, sums up one of the study’s key conclusions: “Big data is especially promising and differentiating for financial services firms. With no physical products to manufacture, data – information – is one of their most important assets, if not their most important. “The business of banking and financial management is rife with transactions, spewing hundreds of millions of them daily, each adding another row to the industry’s immense and growing ocean of data. So the question for many of these firms remains: how do we harvest and leverage this information to gain a competitive advantage?”

The IBM/Oxford study found that 71% of these banking and financial markets firms report that the use of information (including big data) and analytics is

creating a competitive advantage for their organisations, compared with 63% of cross-industry respondents. That percentage had almost doubled since the previous survey, conducted two years beforehand.

Bear adds: “At the same time, these firms are dealing with a very diverse and demanding customer base that insists on communicating and transacting business in new and varied ways, any time of the day or night. “While the banking industry’s structured customer data is growing in size and scope, it is the world of unstructured data that is emerging as an even larger and more important source of customer insight. Investment bankers, financial advisers, relationship managers, loan officers and countless other front-office employees must have ready access to detailed product and customer information in order to make



better and more informed decisions, while also supporting regulatory and compliance reporting requirements.”

BUSINESS-DRIVEN PRAGMATISM

The study also found that banking and financial services organisations are taking a business-driven and pragmatic approach to big data. The most effective big data strategies identify business requirements first, and then begin by leveraging the existing infrastructure, data sources and analytics to support the business opportunity.

“These organisations are extracting new insights from existing and newly available internal sources of information, defining a big data technology strategy and then incrementally extending the sources of data and infrastructures over time,” says Bear.

The study unveiled four key findings that reflect how financial services organisations are approaching big data:

1. Customer analytics are driving big data initiatives

When asked to rank their top three objectives for big data, more than half of the finance industry respondents with active big data efforts identified customer-centric objectives as their organisation’s top priority (55%, compared with 49% of global respondents).

Banks are under tremendous pressure to transform from product-centric to client-centric organisations. Bear says: “This places the client as the central organising principle around which data insights, operations, technology and systems revolve. By improving the ability to anticipate changing market conditions and customer preferences, banks and financial market organisations are seeking to deliver new client-centric products and services to quickly seize market opportunities while improving customer service and loyalty.”

2. Big data is dependent on a scalable and extensible information foundation

The promise of achieving significant, measurable business value from big data can be realised only if organisations put into place an information foundation that supports the rapidly growing volume, variety and velocity of data.

The study asked respondents with current big data projects to identify the state of their big data infrastructures. Only slightly more than half of banking and financial markets companies reported having integrated information, although 87% said they have the infrastructure required to manage this

growing volume of data. The inability to connect data across organisational and departmental silos has been a business intelligence challenge for years, especially in banks where mergers and acquisitions have created numerous and costly silos of data. This integration is even more important, yet much more complex, with big data. Integrating a variety of data types and analysing streaming data often requires new infrastructure components such as Hadoop, NoSQL, analytic appliances, real-time streaming and visualisation, among others. However, it is in these very technologies that banking and financial market organisations are lagging behind their peers in other industries the most.

IDENTIFYING ILLEGAL TRADING

At the more advanced end of the market, NYSE Euronext, for instance, employed big data analytics to find new patterns of illegal trading. The exchange implanted a new market surveillance platform that both sped up and simplified the processes by which its experts analysed patterns within billions of

Datasets are often too large for data analysts to view and analyse with traditional reporting and data mining tools

trades. One key aspect of implementation was the fact that no changes had to be made to the existing exchange data for the solution to yield significantly improved performance.

NYSE Euronext found that the new infrastructure cut the time needed to run market surveillance algorithms by more than 99%, reducing the number of IT resources required to support the system by more than 35%, while improving the ability of compliance personnel to detect suspicious patterns of trading activity and to take early investigative action, thus minimising damage to the investing public.

3. Most early big data efforts are targeted at sourcing and analysing internal data

According to the survey, more than half of the banking and financial markets respondents reported internal data as the primary source of big data within their organisations. This suggests that banks are taking a pragmatic approach to adopting big data, and also that there is tremendous untapped value still locked away in these internal systems. More than four out of five

finance industry respondents with active big data efforts were analysing transactions and log data. This is machine-generated data produced to record the details of every operational transaction and automated function performed in a firm’s business or information systems – data that has outgrown the ability to be stored and analysed by many traditional systems.

4. Educate, explore, engage and execute

Big data requires strong analytics capabilities; it does not create value until it is put to use to address important business challenges. This requires access to more and different kinds of data, as well as strong analytics capabilities that include not only the tools, but the requisite skills to use them. Examining those firms engaged in big data activities, the study revealed that they start with a strong core of analytics capabilities designed to address structured data, such as basic queries, predictive modelling, optimisation and simulations, but lag in core capabilities of text analytics and data visualisation.

The need for more advanced data visualisation and analytics capabilities increases with the introduction of big data. Datasets are often too large for businesses or data analysts to view and analyse with traditional reporting and data mining tools. In the IBM/Oxford study, finance respondents revealed that only three out of five active big data efforts use data visualisation capabilities.

In fewer than one in five of the active big data efforts, banking and financial markets respondents reported using advanced capabilities designed to analyse text in its natural state, such as the transcripts of conversations. IBM distilled the results of the survey into four main stages of big data adoption and progression, along a continuum the firm identified as ‘educate, explore, engage and execute’. These stages will be covered in the CISI CPD seminar this month – see details below.

- To find out more about the CISI’s CPD courses and events, visit cisi.org

➤ Keith Bear, Director of Financial Markets at IBM, will chair the ‘Big data, big opportunity?’ seminar which



will be held in London on 22 September. An edited version of this two-hour event will subsequently run on CISI TV. For full details please visit cisi.org/events

Curse of forward guidance

A REVERSAL OF ROLES HAS SEEN THE PRONOUNCEMENTS OF CENTRAL BANKERS REPLACE MARKET SIGNALS, TURNING US ALL INTO AMATEUR MACRO-ECONOMISTS

◆ ANDREW DAVIS 📷 JOHANNA WARD



There are plenty of reasons not to like the way the financial system is run nowadays. Some cannot bear the way that borrowers' profligacy is condoned while savers are forced to accept ever more meagre rewards for their providence. Others regard today's central bankers as little better than terrorists bent on debasing paper currencies and unleashing an inflationary tsunami that only those with sufficient gold and guns will survive. Some see bubbles forming all around them. Others warn that we stand, Japan-style, on the brink of a deflationary slump.

Spend enough time on the internet and you will find many complaints like these, occasionally expressed with as much eloquence as conviction. I sympathise to a degree with many of them but my own pet gripe is different. The experiments central bankers have engaged in since 2007 may well have staved off something much worse than the downturn we ended up with, but there has been one major downside that shows little sign of disappearing: we are now condemned to live in a world teeming with amateur macro-economists. A greater waste of time and human ingenuity would be hard to imagine.

How did we get here? I think it goes something like this. In the years since the wheels came off, our world has been turned on its head. Once upon a time, economies and financial markets

went about their business day after day producing and consuming, buying and selling, and in the process generated vast flows of information that central banks and governments used to help them decide what to do. If things were looking a bit racy, rates might go up; if the opposite, they might be cut.

It is naïve to pretend information flowed only one way, but the general point stands: market signals were the chief source of information on what was actually going on in the economy.

Nowadays, the formula runs backwards. Instead of markets providing the primary source of

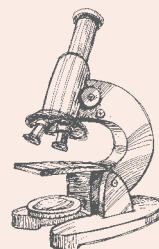
“Central bank watching is now a cottage industry and one that generates gargantuan amounts of commentary and opinion, most of it shallow and repetitive”

information to central banks, the bankers are now the main source of information that guides the markets.

Great numbers of the world's most highly paid professionals hang on the words of the central bankers, deciding how to invest on the basis of what they think they just heard or what they believe they are about to hear. The most learned commentators are called upon to interpret slight changes in the way the financial mandarins express themselves. The system that we have relied

on for many decades is stuck in reverse. Assumptions about what central banks will do and when have replaced questions of price and fundamental value.

Instead of market signals, today we have ‘forward guidance’, perhaps the ultimate attempt to make water flow uphill. This tautologous construct effectively enshrines the reversal that now sits at the heart of the system, asking us all to believe that if the central bankers say things will go a certain way then they will, regardless of what the evidence from the economy and financial markets might suggest. Inconvenient truths such as the



patchy records of central banks as forecasters and the ultimately mysterious nature of a system as complex and chaotic as a modern economy are put to one side. Forward guidance will light our way.

It is hardly surprising that endeavours such as these should have unintended consequences but in retrospect, it is blindingly obvious that if central bankers have become oracles whose pronouncements guide the markets, then there will be no shortage of wise men

and women to interpret their utterances for the benefit of the rest of us. Which brings me back to the curse of the amateur macro-economists.

GIANT ECHO CHAMBER

Maybe I just spend my life reading the wrong things, but I cannot help feeling that far too much effort is devoted to commenting on and explaining the words and actions of central banks. Granted, what central bankers say matters more than pretty much everything else, but central bank watching is now a cottage industry and one that generates gargantuan amounts of commentary and opinion, most of it shallow and repetitive.

It is like living in a giant echo chamber – somewhere along the way the ascent of the central bankers has turned us all into amateur macro-economists, opining on subjects about which we know little or nothing of any real substance. It seems a dreadful waste of talent.

There must be better things for smart people to be doing than repeating each other's opinions on economics. We've moved from a world in which economists spent their time attempting to understand people to one in which people spend their time attempting to understand economists. It is a strange state of affairs and it makes far less sense to me than the world we have left behind.

• To read more about central banks, go to cisi.org/sireview

The green route

Are new initiatives like
the UK Government-created
Green Investment Bank and Unilever's
issuing of a green sustainability bond
here to stay or will they come and go
like many others in this sector?

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“...a culture where people are prepared to speak up can significantly improve behaviour...”

FCA response to the Parliamentary Commission on Banking Standards
October 2013

speeok uo

When you see a problem, speaking up takes moral courage. It helps your organisation maintain integrity, and supports long-term sustainability.

To support a ‘speak up’ culture in financial services, the CISI has developed a new interactive workshop, focusing on the importance of all staff within your company having the knowledge and courage to speak up.

The workshop is delivered in-house, and through interactive voting, discussion and debate, will get staff across your company thinking about how they can, and should, respond to failings, large or small, which impact the standards set by your organisation.

Learn more

cisi.org/speakup