SECURITIES & INVESTMENT
REVIEW
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DECEMBER 2014

Eurozone danger
Europe faces deflation in the wake of the financial crisis

Equitable increase
Pensions changes have spurred growth for equity release

Side benefit
How volunteering can help you

At the helm

THE CISI'S ALAN YARROW ON HIS HOPES FOR A YEAR AS LORD MAYOR

Inside
Review of Financial Markets – see centre pages for in-depth and original academic research

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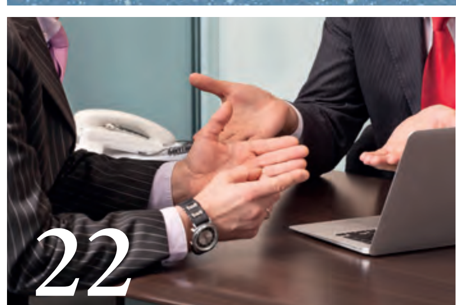

Contents

5 **CITY VIEW**
The CISI welcomes proposals to strengthen accountability in banking

6 **NEWS REVIEW**
News and views from the CISI

11 **FIRST PERSON**
After a year full of the unexpected, *Christopher Adams* looks at four key questions for the New Year

12 **MAYORAL VALUES**
New Lord Mayor and CISI Chairman Alan Yarrow FCSI(Hon) speaks to *Janice Warman*

16 **QUIXOTIC TENDENCY**
Janice Warman on the growing influence of activist investors on the corporate scene

19 **DANGER IN THE EUROZONE**
The eurozone is facing its most serious challenges since the single currency began, warns *Alex Brummer*

22 **PUTTING OTHERS FIRST**
By helping others, you can also benefit your career and company

24 **NEW WAYS TO MANAGE WEALTH**
Heather Connon assesses the impact of fewer long-term, individual wealth management relationships

26 **RELEASING EQUITY**
Since changes to pensions, things have livened up in the equity release market

29 **REVIEW OF FINANCIAL MARKETS**
Turn to the centre pages for the latest academic journal

41 **SHABEER'S GOT TALENT**
Shabeer Booly MCSI on *Britain's Got Talent* and wealth management advice

42 **SHOCK AND AWE**
A new manager is set on improving the performance of his department

44 **CATCHING THE WAVE**
The City could learn a lot from the Royal Navy and its core values

46 **LAST WORD**
Andrew Davis examines the increasing interest in the UK's fintech scene

Do you know

#yourmoney?

Are you a saver or a spender?

Can you spot a good deal?

Take the challenge and find out!

City view

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THE CISI WELCOMES REGULATORS' PROPOSALS TO STRENGTHEN INDIVIDUAL ACCOUNTABILITY AND TO INCREASE PROFESSIONALISM

November's fines for forex rigging, meted out by regulators to six major banks, made the tally of fines this year the highest since 2007. This is a depressing statistic following six years of rhetoric and regulation aimed at reforming the banks and restoring trust in the sector.

It is against this background that attempts by the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) to strengthen accountability in banking through a new regulatory framework for individuals need to be critically evaluated.

The CISI strongly welcomes the regulators' proposals to strengthen individual accountability and to increase professionalism through annual measures of reviewing 'fit and properness', including conduct, which will apply to those at the middle level as well as those at the top of banks. Indeed, the CISI is proposing an annual Certificate of Professional Competence, which will incorporate several 'refresher' tests that can be logged automatically to demonstrate that competence and integrity really are being maintained and built upon, with qualifications, where appropriate, focused on identifying and managing risk.

The main transgressors in the forex rigging were traders and they seem to be virtually beyond reach under the current rules. The spotlight, therefore, also falls – as it must – on those who manage them.

Philip Augur makes the point in the *Financial Times* that "if the dealers involved must take most of the blame, the [FCA] is right to criticise the traders' managers. The chain of command runs up from senior dealers, to desk heads, departmental managers and all the way up to the board… supplemented by oversight from risk managers and compliance officers… this was a systematic collapse of good judgment".

Professional bodies like the CISI constantly remind individuals, firms, clients and other stakeholders that professionalism combines a range of skills, conduct and technical knowledge. Most professions regard

> Most professions regard objectivity as a core value

objectivity as a core value and although the PRA conduct rules are there at a high level – "you must pay due regard to the interests of customers and treat them fairly" – we think they need to be supplemented and believe the PRA should work with professional bodies to strengthen them. Had there been objectivity in evaluating the trading and a critical eye on what was happening, the rot might have been stopped earlier.

At UBS it was reported that the bank had received whistleblower reports about the conduct of forex trading for two years. Here the devil is in the detail of the FCA's proposals in CP14/13, which is found wanting: there is an impressive list of senior management functions, but whistleblowing is omitted! This despite the FCA's statement in its own whistleblowing/financial rewards paper that requiring firms to have effective whistleblowing procedures was something for which senior management should be accountable.

The PRA's Prescribed Responsibilities do include ensuring the effectiveness of whistleblowing policies. It is difficult to see why the FCA and PRA cannot be aligned on such an important area, especially as it is the banks that need to navigate the regulatory requirements of each. Pragmatic, intrusive monitoring will be needed.

For the public, the investor, the client, as well as firms, how can it make sense, as proposed, also to abandon the Approved Persons Register, which, while not fit for purpose, at least provided transparency? We argue that a public register must be invested in and maintained as part of the industry's determination to demonstrate a real commitment to individual accountability.

The CISI calls for dialogue with all relevant trade bodies and professional bodies so that the detailed implementation of such an important proposal for individual accountability can really enable the industry to recover from this appalling scandal, a scandal which marks another low in the sector's reputation.

60-SECOND INTERVIEW

Martin Higgins ACSI is one of the first practitioners to attain the CISI's new level 4 Certificate in Managing Operational Risk in Financial Institutions. Here Martin, a Senior Analyst at BNY Mellon in Manchester, talks about the qualification and how it is helping him in his career

Why did you take this qualification?
To improve my breadth of financial services knowledge and skills. My role entails the co-ordination and implementation of the company's recovery and resolution plans in various different jurisdictions, working with multiple regulators. It requires that I understand the company as a whole – and that includes where the risk 'hot spots' are that could in turn influence the company's ability to be recovered or ultimately resolved.

What benefits has it brought you?
The qualification has not only provided me with the toolkit to be able to spot operational barriers to recovery or resolution, but also an understanding of how to implement solutions to overcome those obstacles.

Would you recommend this qualification to other people?
Definitely. The qualification is useful for people like me who don't work in operational risk but need a good grasp of the subject in their job. Equally, it is a gateway to further higher-level CISI operational risk qualifications, including the level 6 Diploma in Investment Operations, for specialists in this area.

Any tips for fellow candidates?
Study the qualification workbook, which benefits from being written in easy-to-understand language. But don't stop there – read around the subject to make sure that you truly understand the processes and tools being described. A challenge is to find a way that works for you in memorising lists of data – I found mind mapping to be a helpful tool.

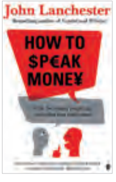
Do you have your sights set on further qualifications?
Yes. I have signed up to take the Certificate in Corporate Finance. This is with the aim of then sitting the level 6 Diploma in Corporate Finance. CISI qualifications help you to become recognised as a professional within your field. I have already obtained the Investment Advice Diploma.

Was a financial services career always on the cards for you?
No. Upon leaving university (where I studied computing) I got a job in financial services simply to help pay down my student debt until Google or Apple came calling! I worked on the IFA support desk at a call centre. It was here where I realised how interesting financial services is, and now, as the owner of a small library of finance books, I can safely say that I have never looked back.

Qualification factfile

- Examinable by computer-based testing, providing candidates with the flexibility to sit the exam all year round
- 1hr 45min, 70 multiple-choice question exam
- Can be taken as a standalone Certificate but also leads to the level 6 Diploma in Operations, the CISI's higher level pathway for operations specialists
- For further information, see *cisi.org/morfi*

Book review: *How to Speak Money*



John Lanchester, 2014

Every now and then a book comes along that succeeds in bridging the enormous gulf between two vastly different worlds.

This is one of them. John Lanchester has made it his mission to translate the economic reality of the world we live in for the benefit of those for whom the language of money is a foreign tongue.

He is already well known not only for his novels but also for earlier books on the financial crisis.

This one does what it says on the tin – I defy anyone not to enjoy every word. And with Christmas looming, it would make a great stocking-filler for any member of your family who wants to know what you do all day.

"There's a huge gap between the people who understand money and economics and the rest of us," he declares. "It's a gap we need to close." And then he proceeds to do it.

As he says, the details of modern money are often complicated, but the principles underlying those details aren't.

Janice Warman

READER OFFER

Readers can purchase *How to Speak Money* from Faber & Faber at 40% off the RRP of £17.99. The offer price is £10.79 (£13.54 inc. P&P).

Go to http://bit.ly/1zGyhov and enter the code HOWTOSPEAK to obtain your discount.

The offer is valid until 1 March 2015.

Ask the experts: Securitisation

Where are we seeing the biggest growth in securitisation markets?
Securitisation is the process of moving assets such as loans originated by a bank into a vehicle to back the issuance of securities. Through tranching the risk, securities of different qualities can be issued. I think the market needs to be enhanced before you see substantial growth. There needs to be a class of securitisations that are simpler and guarantee high quality in terms of due diligence standards and the quality of loans that are going in the pool. That would encourage more accuracy. In America, this is achieved through agencies such as Fannie Mae and Freddie Mac, but Europe still has to develop a standardised, transparent and simpler securitisation market.

European securitisation has performed much better than American residential mortgage-backed securities, for instance, but investors are still nervous and actually, there was never that much liquidity in the securitisations that were sold in Europe. So I think the goal should be to create more investor interest, more liquidity in the market and much more confidence. Then there would be good reason to think about whether securitisations should be exchange-traded to see which are more actively traded.

What are the risks for investors?
I think there are two types of risk. One is that investors often don't really understand what they have bought and that is where greater simplicity, shorter prospectuses, standard material and guaranteed high quality would help. With the complex tranching of structures and the changing nature of loans in the pool, investors don't fully understand the risks. I don't think we are seeing that in the UK market, but we are starting to see a greater variety of high-risk loans going into some of the US securitisations again. The second type of risk is the lack of liquidity in the different instruments. Both of these issues have to be dealt with.

How can authorities enhance the securitisation market?
It is going to take a push from the authorities to make these changes. In the run-up to the financial crisis, we saw some core market failures in the global securitisation market and I don't think those have been fully addressed.

In 2008, I chaired a global industry working group for the Institute of International Finance. That came out with some extensive recommendations, which have not really been taken on board. One of the recommendations was that there should be an estimate of what the loss given default would be by tranche, not just the ordinal structure. This is one area where the whole revitalisation of the market needs to be quite carefully thought through, in order to deal with the failures in the market in 2006 and 2007.

Will greater securitised lending help improve Europe's economic recovery?
We need to get the private markets going again, so that the banks can secure more funding direct from the market and can get the loans off the balance sheet. Securitisation does this, but you have to have much more confidence around the market for that to really pick up. Globally, strict leverage ratios have been placed on the banks. It is easier for banks in America to move loans off the balance sheet into vehicles, because they can move more loans into securitisation structures. This is much harder in Europe. The authorities need to look at the market failures that affected the securitisation market in 2006 and 2007 and to ask: "What do we need to encourage the market to become, in order to avoid the risk of repeating those failures?"

Patricia Jackson, EY Strategic Adviser, Risk Governance and Regulation

Review of Financial Markets completes first volume

This edition of the *S&IR* contains in its centre pages the fourth issue of the CISI's academic journal, *Review of Financial Markets* (*RoFM*). It marks a successful first volume of the *RoFM*.

The 12-page publication has, since its launch, featured a wide range of peer-reviewed research papers from practitioners and academics around the world related to wealth management, capital markets and banking. Gino Landuyt from Luxembourg Financial Group and a member of the journal editorial panel (left) said: "*RoFM* was introduced with the objective of establishing itself as the recognised research publication for the securities and investment industry and it certainly is proving its value. It is interesting, informative and relevant, helping CISI members to look beyond their specific job roles and keep in touch with a variety of practitioner-orientated research."

The latest issue includes an editorial from Editor Moorad Choudhry FCSI, Professor at the Department of Mathematical Sciences, Brunel University, and three diverse papers: Michele Lizzio, from Deloitte in Milan, gives his take on the cost of capital; David Moskovic, of Royal Bank of Scotland, examines the importance of understanding correlation in derivatives risk management; while Michael Widowitz, based in Frankfurt with the Boston Consulting Group, considers the use of quantitative analysis to improve non-performing loan management in European banks.

- CISI members are invited to submit papers to *RoFM* for consideration. For submission guidelines, turn to page 12 of *RoFM* or see *cisi.org/academic*

The knowledge

How to Speak Up with confidence

The CISI has launched a Speak Up initiative designed to help employees raise concerns with their employers about potential or existing misconduct issues before they become entrenched problems. Here, Rebecca Doodson, Manager of Ethics and Integrity at CISI, gives five top tips on how to Speak Up with confidence.

1 **SPEAK (See, Prepare, Evaluate, Act and Keep trying):** Once you See something that you don't think is right, Prepare yourself to raise the concern and Evaluate the situation before you Act. If you don't get an adequate response – Keep trying.

2 **Be informed:** Familiarise yourself with your organisation's Speak Up/whistleblowing policy (if it has one). Also, knowing more about what protection is available to those who Speak Up under legislation can help improve your confidence. In the UK, the Public Interest Disclosure Act offers protections for whistleblowers.

3 **Follow the steps:** There are four stages of Speaking Up – internal (informal); internal (formal); external (regulator); and external (public disclosure). While in some cases it may be appropriate to go straight to the regulator, these are exceptional. Try raising your concern internally first.

4 **Keep calm and carry on:** Speaking Up effectively is about sticking to the facts. You don't need to prove the misconduct, just report what you have seen calmly and objectively.

5 **Seek advice:** If you are unsure, discuss your concerns with a colleague or ask for help from your professional body or from experts such as the whistleblowing charity Public Concern at Work. In this copy of the *S&IR* you will find a copy of the CISI's Speak Up guide for members, designed to give you background, guidance and top tips on Speaking Up. Members can take the free Speak Up Professional Refresher elearning module at *cisi.org/refresher* to test their knowledge.

Further information:
cisi.org/speakup

Speak Up will be the topic of a series of CISI regional roadshows around the UK for members, starting in January 2015, with the opportunity to discuss real-life scenarios and decide 'what would you do?' with interactive voting options. For information about locations and dates, see cisi.org/cisiroadshows.

Art in the City

There are dazzling works of art in the City and in corporate collections across the world. In this issue, we look at the Banco Santander collection.

The Annunciation, *Dominenkos Theotokopoulos, El Greco, 1541-1614, from the Banco Santander collection near Madrid*

Banco Santander has a clear cultural commitment that forms part of its policy of corporate social responsibility.

Among its projects, it manages, conserves and promotes its art collection, organises exhibitions and lectures, supports arts-related educational programmes, and contributes to the heritage of the world through its activities with museums and cultural institutions.

In all, it owns some 750 major works The art covers the centuries, with a wealth of works by El Greco, Van Dyck, Tintoretto, Rusiñol, Miro, Picasso, Chillida and Serra, among others, held at its headquarters outside Madrid.

There is a website and a book about the collection, which is represented on Google's new online Art Project (*google.com/cultural institute/home*).

The Banco Santander Foundation, set up in 1991, has shares in the bank whose dividends fund its work. Hence in good times there is more to spend – and in hard times, the Foundation and the art programme are secure.

- More information about corporate art collections around the world can be seen in the recent book *A Celebration of Corporate Art Programmes Worldwide*, by Peter Harris and Shirley Reiff Howarth (*artworldeurope.org*).

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 asks what the future holds for retail banking. Is there still life in high-street banking, or will the emergence of digital technology and alternative investment models kill it off?

• View the digital edition and leave your comments at *cisi.org/sireview*

New role for Ruth Martin

Ruth Martin

Lydia Romero

Ruth Martin is looking forward to a new role with the Church of England after stepping down as CISI Managing Director at the end of November.

She has been appointed as Diocesan Secretary to the Anglican Diocese of Southwark.

The post will involve leading the organisational aspects of the Diocese, which covers more than 2.5 million people living in South London and East Surrey.

Ruth spent 12 years at the Institute, ten years of which were as Managing Director.

Lydia Romero is the new Director of Learning at the CISI.

Lydia has joined the CISI from BPP University London where she was Head of Programmes at BPP Business School. She succeeds Ruth Martin in a number of areas. Previously Academic Programme Manager at the Institute of Continuing Education, University of Cambridge, Lydia has also worked with Time Life Inc London and Virgin Atlantic Airways.

Muscle in on this gym offer

Looking to get into shape in 2015? Through CISI Select Benefits, you can access corporate rate gym membership at over 2,500 UK gyms with a free Incorpore pass.

Participating gyms include Virgin Active, Fitness First, DW Sports, Nuffield Health and LA Fitness. Your Incorpore pass will save you money on your gym membership, even if you are already a member at one of the gyms. You are also entitled to a guest pass or free trial to experience the club prior to joining. Access your free Incorpore gym pass via *cisi.org/mycisi*.

*Terms and conditions apply. See website for details. Offers subject to change without notice.

The *S&IR*'s quick quiz features questions from CISI Professional Refresher, an online learning tool. This popular product consists of 60 modules covering topics including anti-money laundering, the UK Bribery Act and information security and data protection. The answers are on page 11.

1. When does the money laundering offence of 'tipping off' occur?

A When a criminal reveals evidence about his partners in crime
B When a person discloses that a report has been made and/or information that is likely to prejudice an actual or imminent investigation
C When an account or relationship is closed due to suspicion
D When you discuss your concerns with your manager

2. One of the requirements of the Remuneration Code is to:

A Establish minimum and maximum limits in relation to bonuses to avoid conflicts of interest in relation to sales practices
B Ensure that all regulated firms have a remuneration policy in place
C Ensure that all regulated firms make disclosure to the regulators
D Ensure that firms have measures in place to avoid conflicts of interest

3. Which of the following categories is not considered to be a main asset class when diversifying a client portfolio?

A Fixed interest
B Property
C Emerging markets
D Equities

4. Which statement best describes the main attractions of arbitrage strategies for investors?

A Returns tend to be high, but depend on rising markets
B Returns tend to be low and depend on falling markets
C Returns tend to be consistent regardless of the direction of markets
D Returns tend to be volatile and rely on a confident mood in the markets

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

Danny Corrigan, Chief Executive Officer, CME European Trade Repository Ltd

Danny Corrigan's greatest professional love has always been the Russian financial markets. It stems from a phone call he had in the mid-1990s with a former colleague, who explained that these markets afford interesting opportunities. A plane ride and an interview later, Danny and his family moved to Moscow, where he worked as Head of Treasury Markets at MFK Renaissance Capital Ltd for two years.

"The Russian markets started in the mid-1990s, creating a 20-year concertina of the developments that occurred in other markets over several hundred years," he explains.

But like many working in financial markets, Danny oscillates between the safe and the risky. In 1999, Danny took a step back from risk, returning to London to work as a consultant for the London Clearing House (LCH).

In the years that followed, Danny worked in the repo market in Sydney and London. The highlight of his career was being seconded to LCH to manage the unwind of the Lehman Brothers repo portfolio, after its default in 2008. "I worked with a young, fresh-faced Dan McGuire, then a risk employee at LCH, now Global Head of Swapclear," he recalls. "It was a tremendous experience working with true professionals to take risk out of the market."

> "The role has allowed me to work with a great set of people"

He returned to Moscow for a further two years, as a Director for ING Eurasia. Then it was back to London to run an OTC Derivatives desk at ICAP.

As CEO at CME European Trade Repository, Danny now works in a closely regulated, strategically important role, central to the functioning of the derivatives market. It may not present the same risks as some of his previous roles, but it's an exciting place to be. "The infrastructure didn't exist, in this form, before the financial crisis," Danny says. "It's allowed me to work with a peerless team of people."

His advice for those starting out in the City is to study for a professional qualification, "get up early" and be prepared to work on Sunday afternoons if need be. The latter is the only way Danny has managed to write five books and manage youth football teams alongside his career.

• 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. Here are some dates for your diary.

24 FEBRUARY
THE CITY DEBATE 2015

Mansion House, Walbrook, London EC4

The City Debate has been running since 1996 courtesy of the Futures & Options Association, and it has become established as one of the City's most entertaining and intellectually stimulating debating forums.

It provides the City's international financial services community with the opportunity to address topical issues which have the potential to affect the current and future development of the industry.

This year's event, held jointly by Centre for the Study of Financial Innovation and CISI, comprises a black-tie dinner followed by university-style debate, featuring leading business and political figures. More details will be announced shortly.

OTHER HIGHLIGHTS FOR THE NEW YEAR INCLUDE:

- 22 January: Public speaking – how confident are you? (Manchester)
- 28 January: Equity valuation and mean reversion (Liverpool)
- 30 January: Guernsey Annual Dinner
- 3 February: Training and competence healthcheck and review (London) *RDR Annual CPD*
- 10 February: Jersey probate and wills – implications for non-Jersey residents
- 26 February: Northern Ireland Annual Dinner
- 4 March: East Midlands Annual Dinner
- 6 March: Jersey Annual Dinner
- 17 March: Pension reform 2014 and beyond (London) *RDR Annual CPD*

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

Key questions for the New Year

WILL INTEREST RATES AND HOUSE PRICES RISE? WILL THERE BE A EUROZONE RECESSION? A STOCK MARKET CORRECTION? WE LOOK AT THE NEXT 12 MONTHS

CHRISTOPHER ADAMS JOHANNA WARD

It has been a year full of the unexpected. The bond market failed to collapse, oil prices have tumbled and optimism about economic recovery at the start of 2014 has given way to renewed wariness. With the usual caveats on predictions, here are four key questions for 2015 and my best shot at answering them.

Will the Bank of England raise interest rates?
Yes, but only towards the end of 2015, and then by a quarter of one percentage point from the record low of 0.5%.

After what looked like a strong rebound in growth, and plaudits for the Chancellor George Osborne, there are now concerns that the recovery may not be as robust as thought.

Yes, the remaining slack in the economy might be small, as the more hawkish committee members argue, and that means a build-up in inflationary pressure could be around the corner. But survey evidence also points to weakening service sector activity and mortgage approvals in the housing market are dropping, which are also likely to weigh on growth.

Expect the US, where the recovery is stronger, to move first on interest rates. The UK will follow in the autumn, and possibly as late as November 2015.

Will the eurozone suffer a triple-dip recession?
While 'technical' recession is a risk, a return to the dark days of the eurozone debt crisis, and a period of pronounced economic contraction, is unlikely.

First, a weaker euro will make exports from the single currency area more competitive, benefiting manufacturers. Second, the European Central Bank will embark on full blown 'quantitative easing', or purchases of eurozone sovereign debt, before that happens.

More likely is that prolonged disinflation, and even an outright slide into deflation or falling prices, weighs on recovery prospects, keeping the continent mired in post-crisis stagnation.

Will my house be worth more or less at the end of 2015?
This is hard to call. The likelihood is it will be worth about the same. London house prices have been inflated by a combination of record low interest rates, stimulative government policy and cash-rich foreign buyers snapping up prime property.

Moves to tighten lending, caps on loan-to-income ratios and renewed unease over the economy have taken some of the heat out of the market.

Nationwide says the average UK house price hit an all-time high in October, but that the annual rate of growth has been slowing, albeit to a still pacy 9%. Chartered surveyors have been reporting falling buyer enquiries. Expect to see a few month-on-month falls over 2015.

Are we in for a stock market correction?
It would be easy to say that equities, at around record highs on Wall Street, are due for a slide and that the bond market is a bubble about to burst.

True, successive waves of cheap central bank money, notably from the Federal Reserve, have fuelled gains in asset prices. The market wobble in October, when crisis-era volatility briefly returned, was a reminder of just how dependent the markets have become on central bank-administered morphine. But that also makes forecasting all the more difficult.

As Goldman Sachs put it in a recent note: "Seven years after the start of the financial crisis, economic and financial conditions remain far from normal."

Equities should continue to outperform bonds, but with much lower absolute returns than enjoyed since 2010. This period of global 'moderation' may continue for some years and is likely to end as a result of either the bursting of a bond bubble as interest rates start to rise, or "significant further valuation expansion" of equities.

If those valuations become stretched, we could well see a return of the kind of volatility we saw in October.

This is the final column from Christopher Adams. He is now the Financial Times' *Energy Editor*

Anthony Hilton, 2014 Business Journalist of the Year, will be taking over First Person in 2015.

In the know answers: 1.B, 2.D, 3.C, 4.C

“My theme is six simple words – creating wealth, giving time, supporting people”

Mayoral values

NEW LORD MAYOR AND CISI CHAIRMAN ALAN YARROW, CHARTERED FCSI(HON) ON VOLUNTEERING, OLD-SCHOOL VALUES AND THE VITAL ROLE OF THE CITY

JANICE WARMAN JOHANNA WARD

Alan Yarrow, Chairman of the CISI and the new Lord Mayor of London, is the very model of a modern man of the City. His distinguished career in financial services spans more than 40 years at Kleinwort Benson and Dresdner Kleinwort, and a string of appointments that include the Practitioners Panel of the former regulator, the Financial Services Authority (FSA), The Takeover Panel, the British Bankers' Association (BBA) and the London Investment Banking Association.

He is an advocate for the old-school type of banking – and strives to live and work by the tenets of that most traditional and British of poems, Kipling's *If*.

When I meet him at the CISI headquarters, he is about to take up the ermine robes of his new job and is full of enthusiasm for a role that will see him travel for 100 days to 30 countries and make more than 650 speeches as ambassador for the City of London.

WEALTH OF OPPORTUNITY

The prospect would leave many people exhausted. Not Yarrow: "My theme is six simple words – creating wealth, giving time, supporting people," he begins. "The whole of my appeal is going to be about those concepts. The creation of wealth is a good thing – the question is how you use that wealth. Is it a wealth of opportunity, or is it a wealth of money?

"The reality is that you've got to create wealth before you can actually help those less able to help themselves. It's the logical, chronological order. Anybody who tries to change that order, by putting creating the wealth at the end – it doesn't work."

We are effectively in a centre of wealth creation, he explains. "And the City should be judged on how it uses that wealth.

"It's the creation of growth and jobs. And through the creation of jobs and employment, effectively, is how we help the economy and the country.

"In Greater London, there are 600,000 people employed in financial services and support services. There are over 1.4 million in the rest of the country supporting those financial services."

> *"The reality is that you've got to create wealth before you can help those less able to help themselves"*

Yarrow will be travelling; but he will also be hosting upwards of 120 visits of prime ministers, finance ministers, central bankers and others.

He is passionate about the ethical standards that underlie the CISI, and explains: "I come from a background of being a partner, where you're jointly and severally liable. And that's important behavioural conditioning. So that you made sure that your fixed overheads were low, but your variable income reflected the profitability of the company.

"I say that because you benefited when things went well, but you also suffered detriment when things went badly wrong. And so you effectively managed and handled the risk, both good and bad."

That discipline, he explains, was lost after Big Bang, the deregulation of the financial markets in 1986. And while none of the CISI's members were the cause of the financial crash, "they have suffered the opprobrium of the public.

"So we led the way in putting together a code of good practice for our members. And we now have everybody signed up to say that they accept the code as being the way they should manage their business life. It's necessary for the industry to show that they recognise the problems of the past, and to minimise the possibility of it happening in the future.

"The whole point about the CISI, which is so powerful, is that we are effectively practitioner-owned. And out of our 40,000 members, 750 of them give their time for free. They volunteer to share their experiences, to set exam questions, and make sure that they are appropriate."

It's a peculiarity of the Anglo-Saxon world, he maintains, that volunteers are reflected so much in society. "The thing that was really wonderful about the Olympics wasn't just the sport, it was the volunteers, the people who actually showed you the way to your seat, or showed you how to get to the Olympics." The same was

THE NEW LORD MAYOR ALAN YARROW GREETS THE CROWD AS THE PROCESSION PASSES ST PAUL'S CATHEDRAL

CLIVE TOTMAN

true, he adds, of the Paralympics and the Commonwealth Games.

VALUE OF VOLUNTEERING

The value of volunteering is beginning to be recognised, he says. Andy Haldane, Chief Economist at the Bank of England, said in a recent lecture that the monetary value of volunteering equates to £24bn, or 1.5% of GDP. "If you increase that by the feeling of wellbeing in the person, it improves their health, it improves their productivity, and you could double that figure."

Yarrow's own background is impressive: he left Dresdner Kleinwort in December 2009 after 37 years; in his later years there, he was Group Vice Chairman and Chairman of the UK bank.

He stepped down from executive management in 2000 (at which time "I was responsible for about 1,200 people around the world in 18 different countries") but was invited to stay on and name his role.

"I decided that I would go out and do those things which I wished someone had done for me when I was running a business. And so I was asked if I would join the Takeover Panel. I was invited to be on the FSA Practitioner Panel, a statutory body that sat above the FSA.

"And I was Chairman of the London Investment Banking Association, which was very powerful as an advocacy group.

"We, the City, are judged, not by the fact that we've got it wrong but what we do to put it right"

"I was also Vice President of the BBA. So all those things basically gave me big access to government, to the Treasury, and obviously, the regulator."

His working life has routinely involved so much travel that his new schedule holds no fears for him – "I was always on a plane, always talking to international regulators, always trying to get business from governments. So that was my natural habitat, effectively.

"What the Lord Mayor does isn't dissimilar – but the Lord Mayor gets access to emirs, kings, ministers, presidents, central bank governors and finance ministers."

And the Lord Mayor's real soft power is his convening power, Yarrow points out. "His ability to bring people together, into a neutral, apolitical background, which is the City, to discuss issues of the day, or issues of the future, or even, in business, issues of the past when it comes to discipline."

CORRUPTION

Top among City issues today has been the issue of corruption. "It's a pity it's got to this stage, but I do believe that we, the City, are judged, not by the fact that we've got it wrong, because we've got to be allowed to get

it wrong. It's what we do to put it right, and how the discipline is effectively enforced."

"How optimistic do you feel about change for the better?" I ask. "Has the regulatory pendulum swung too far? Has risk been squeezed out?"

"The pendulum, without doubt, swung too far one way. And now, I fear, it's swinging too far the other way. And it's about our ability to moderate these excessive swings. My thought, very strongly, is that there was a loss of focus in the process of the early part of the noughties, that people thought about themselves, and not about their client."

This was driven by an inappropriate reward system, he says, but without detriment. "You cannot have a one-way option." He uses an analogy:

"On average, people trust the police. If that trust were lost, there would be a huge onus on the police force to try and maintain good behaviour. And regulations are very similar. If the regulators lose the support of the industry they're regulating, that is a bad move. I suspect we're getting quite close to that."

SIR FRANCIS DRAKE

Yarrow is a descendant of Sir Francis Drake, who in a move that perhaps Yarrow hopes the worst aspects of the City will emulate, turned from piracy and slave-trading to heroic pursuits, including helping to defeat the Spanish Armada. His *Golden Hind*, which circumnavigated the globe in 1577–80, appears in Yarrow's crest.

Fittingly, Yarrow's family became shipbuilders, starting in the 1870s in Poplar, East London, where his grandfather "built the fastest launches on the Thames", then constructed "torpedo boats, which became the fastest naval ships in the world". The company – now owned by British Aerospace Systems – is probably the longest-lasting naval shipbuilder in the country, he says.

He is married to Gilly, a former teacher, and they have two sons. Their younger son, Guy, has just married; their elder, disabled son, Max, lives in sheltered accommodation in Dorset.

"Gilly gave up teaching to look after the boys, but she stayed in education. She was Chairman of Governors at a school called Finton House in Wandsworth, and a governor of the local comprehensive school."

An experience like this, he says, "either brings you closer as a couple, or it tears you apart. So we are much closer; hopefully, Gilly feels she's had all my support. Living with it is a humanising element, but at the end of the day, you know, we are very well aware of the pressures that people suffer from."

THE 'CAP OF MAINTENANCE' STITCHED ONTO THE BACK OF THE LORD MAYOR'S SCARLET GOWN IS A MEDIEVAL SYMBOL OF NOBILITY AND SPECIAL HONOUR

Which is why Yarrow's chosen charities for his year as Mayor are Scope, which works to improve opportunities for disabled people, and Mencap, the UK's leading learning disability charity. Between them, they will receive 70% of the funds raised. The couple also have an interest in art, and so the Royal Ballet School, the London Art School in Kennington and the Royal Academy of Arts will each receive a share.

LOVE OF ART

Yarrow's love of art goes back a long way. He and his friend David Stileman, who was later his best man (and, later still, became Chairman of Standard Chartered in the US) used to share a flat in London's Earls Court. Both used to paint, "and I used some of my paintings to pay for the rent" – although, he says, laughing: "I suspect my landlord was more interested in the frame than he was in the picture."

His artistic passion hasn't gone away. "At this busiest period of my life, I have picked up a paintbrush again for the first time in 35 years. It's a great way to unwind." Although as he put on the ermine and climbed into the golden coach for the Lord Mayor's procession through London, Alan Yarrow may have reflected that it could be his last painting for some time.

THE CV

PRESENT LORD MAYOR; CHAIRMAN, CISI; DIRECTOR, TURQUOISE GLOBAL HOLDINGS LTD AND FIXNETIX LTD; TRUSTEE, POLICE FOUNDATION; SENIOR ADVISER, KLEINWORT BENSON GROUP

2010–14 CHAIRMAN, KLEINWORT BENSON GROUP

2004–10 DEPUTY CHAIRMAN, FSA PRACTITIONER PANEL

2007– MAGISTRATE; ALDERMAN; ALMONER, CHRIST'S HOSPITAL

2004–9 CHAIRMAN, LONDON INVESTMENT BANKING ASSOCIATION (LIBA)

2002–8 CHAIRMAN, COMPLINET

1995 APPOINTED TO THE GROUP BOARD OF KLEINWORT BENSON, RESPONSIBLE FOR SECURITIES

1972 JOINS GRIEVESON GRANT; BECOMES PARTNER IN 1981

Quixotic tendency

US-STYLE SHAREHOLDER ACTIVISM HAS LANDED IN THE UK – BUT THE BRITISH METHOD OF PERSUADING COMPANIES TO CHANGE IS RATHER MORE SUBTLE

JANICE WARMAN

The news that Sotheby's Chief Executive Bill Ruprecht had been toppled by US activist investor Daniel S. Loeb came as no surprise to those who have been watching the battle that began almost a year ago with Loeb's purchase of a stake in the company and his public accusations of "lacklustre" leadership and extravagance.

But Loeb's victory at the venerable British auction house brings home the fact that this style of US shareholder activism – characterised by Loeb and his fellow billionaire Carl Icahn – has landed firmly in the UK. A little like the US soldiers during the Second World War, they are flush with cash – and they are over here.

Dan Loeb and his fellow directors at his Third Point hedge fund, who secured board seats in May, were right about Sotheby's. How, asked Loeb, could a company with turnover in the billions make this little profit – and such low dividends? The problem, explains Ivan Macquisten, business analyst and Editor of the *Antiques Trade Gazette,* is that there are essentially only two ways that auction houses make money – they can charge the buyer a fee and they can charge the seller a fee.

"The traditional auction house, especially at the top end, is quite an inefficient business model in many ways. Sources of revenue remain restricted, while costs can explode in many directions, such as salaries, administration and marketing."

What is true of auction houses is true of other industries: there is always room for further efficiencies. Carl Icahn is the United States' most renowned activist investor, known among other victories for his involvement with Chesapeake Energy, where the chief executive was running a hedge fund on the side, and more recently for persuading eBay to spin off its digital payments business, PayPal, prompting the departure of its chief executive. He has also just won a battle with Hertz – where Mark Frissora has been replaced as Chief Executive by a successor whom Icahn has personally approved.

Carl Icahn has won a battle with Hertz, where the Chief Executive has been replaced

Why is activism so powerful in the US? Firstly, the view of activists as 1980s-style 'corporate raiders' has been well and truly buried, according to the Chair of the Securities and Exchange Commission, Mary Jo White. She points out that activist investors may only own 1% of shares, yet "there is widespread acceptance of many of the policy changes that so-called 'activists' are seeking to effect." They have, therefore, essentially won government sanction, says Josh Black, Managing Editor of the 2014 *Activist Investing Annual Review*.

Hardie

HOSTILE TAKEOVERS

"In the late 80s, some investors were referred to in that way because of the climate of hostile takeovers and asset stripping – the key difference is that today's activists are aligned with other

> “The UK is seen as the most activist-friendly jurisdiction in Europe”

shareholders and do have to generate a return for them,” adds Black. “More institutions and pension funds are focused on what shareholders can do to improve companies and a lot of questions are asked about what they could do to ensure companies are proceeding in a sensible fashion.”

But where the US is leading, Europe and the UK are following fast. Fund managers such as Guy Jubb at Standard Life and Neil Woodford of the top-performing Woodford Investment Management are not corporate raiders in the same way as Icahn, but they are active investors who strongly influence the direction of the companies with which they engage. Woodford, for example, helped to block the merger of BAE Systems with its European defence rival EADS in 2012 because he felt the company would become a puppet of the French Government. He also holds a significant stake in AstraZeneca as he believes its rejected suitor Pfizer might return.

> *Woodford helped to block the merger of BAE Systems with its European rival EADS*

Activist Insight is a global information source on activist investment. *Activist Investing in Europe*, its most recent report, in association with US law firm Skadden, Arps, says that the UK is seen as the most activist-friendly jurisdiction

in Europe, "judged on its regulatory regime and the sentiment of institutional investors. This has led to a high number of activist campaigns and managers focused exclusively on the UK, including RWC Partners, Toscafund and GO Investment Partners." Cevian Capital, Elliott Associates and Sandell Asset Management also have offices in London.

INSTITUTIONAL INVESTORS

Activists with experience of the UK market say the ability to requisition a shareholder meeting with just 5% of the investor base is the most powerful of the tools at their disposal, and often encourages directors to give shareholders a private hearing first.

Institutional investors are activists too, maintains the report, particularly in their opposition to management on remuneration issues, a problem that has resurfaced in 2014 following 2012's 'shareholder spring'.

However, while institutions are said to be supportive of activists in private, they are less likely to praise individual activists in public. Nevertheless, UK shareholders are under pressure to be more vocal, with political drives to increase shareholder engagement. Recent takeover battles have seen institutions arguing publicly over deals, a debate necessitated by changes to takeover rules, which may deny shareholders the opportunity to consider an offer if they don't force management to engage with the bidder.

The UK is the second most active market in the world, although it is a long way behind the US, says Black. "The trend of shareholders and corporations working more closely together to improve shareholder value is going to continue to be an issue. Some activist investors in the US have looked at the UK and several advisory firms are discreetly setting up offices there, although this could continue at a trickle rather than a stream."

MORE ENGAGED

Politicians, the press and regulators are calling for shareholders to be more engaged with portfolio companies, rather than simply exiting a stock if they are unhappy. A Collective Engagement Working Group has been formed by the main UK institutional shareholder representative bodies (the Association of British Insurers, the Investment Management Association, and the National Association of Pension

Matt Herring

Funds). Its primary aim is to identify how investors can work together in their engagement with listed companies to improve sustainable, long-term company performance and overall returns to

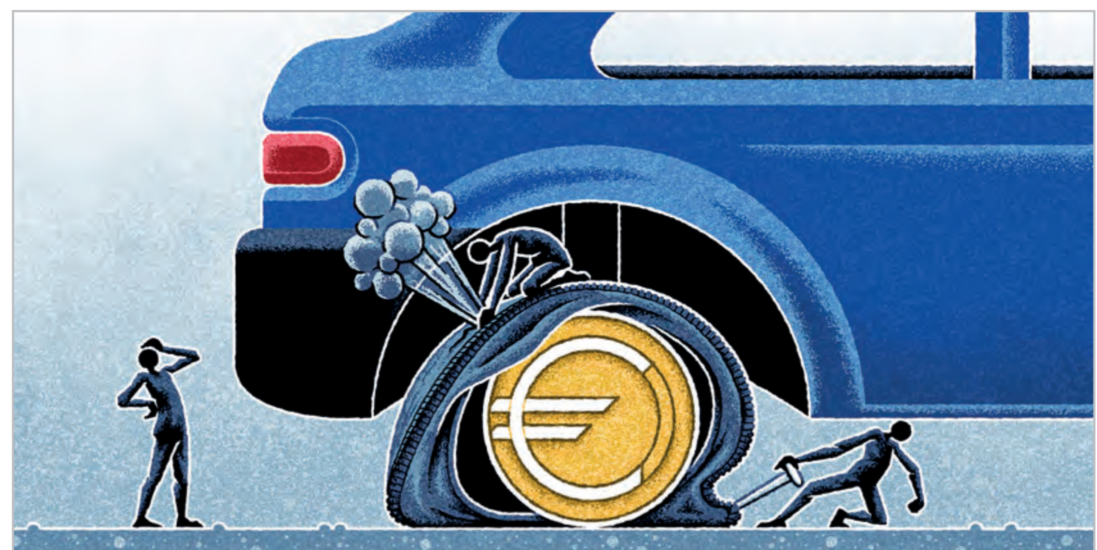
The UK is the second most active market in the world, but a long way behind the US

shareholders. The Working Group has now created the Investor Forum, which is open to institutions wishing to engage with UK-listed companies, including asset managers, asset owners and international investors.

These developments, say Scott Hopkins and Lorenzo Corte in the report, "have the potential to create a 'perfect storm' of shareholder activism in the UK. The forecast is for levels of activism to continue to rise; boards of UK companies should be aware and prepared to respond." It's all a far cry from 20 years ago, when the nearest we came to activist investors were holders of a single share who were in it for the tea and biscuits at the AGM – and the chance to put a question to the chief executive. Now, they are a real force – hunting the corporate seas like sharks sensing blood in the water. Their influence is growing and their goal is to turn companies around, clear out incompetent or greedy management – and make a great deal of money out of it.

As 2015 approaches, what can we expect? "We will see at least a dozen companies next year, perhaps AIM-listed companies and a couple of FTSE 250 companies, being looked at by activists," says Black. "And a number of quarrels between the companies and their institutional shareholders."

As Macquisten points out: "The battleground is value versus values – value for shareholders measured against long-held values in established businesses. No side is ever 100% right, but one has to ask the question: if businesses are performing to the optimum, where is the opportunity for activist shareholders?"



Danger in the eurozone

THE REGION FACES ECONOMIC STAGNATION, WORSENING FISCAL IMBALANCES AND A BANKING SYSTEM STILL REELING FROM THE FINANCIAL CRISIS

ALEX BRUMMER MATT KENYON

The eurozone is facing its most serious challenges since the single currency was launched almost 15 years ago. Across the region, economic stagnation has become endemic, fiscal imbalances have become worse and the banking system is still suffering from the financial crisis of 2008.

Each of the three biggest economies is stagnating. Italy is going through a prolonged period of contraction with output stumbling heavily in 2012, 2013 and 2014 and forecast to tumble again in 2015. Growth has ground to a halt in France.

The eurozone also finds itself at odds with the European Commission in Brussels over its failure to meet budget targets. Most seriously of all, Germany's economy, which accounts for some 24% of the total output of the eurozone, is also stuttering.

As an export-led economy, Germany is suffering from slowdown in China and slumping demand among its European neighbours. Business confidence is being heavily damaged by geopolitical uncertainty in the shape of the stand-off between Russia and the West over Ukraine.

The International Monetary Fund (IMF) forecasts that output across the eurozone region will rise by just 0.8% in 2015, barely enough to have any impact on disastrously high unemployment levels. As if slow growth is not worrying enough, it has been accompanied by a period of falling prices. Consumer price inflation is barely in positive territory at 0.3%, far below the 2% target set by the Frankfurt-based European Central Bank (ECB). The combination of slow growth and falling prices has given rise to acute fears of a lengthy period of deflation.

DEVALUATION

Deflation is often associated with stagnating economies, where the prices of goods and services fall. If deflation is prolonged, wage levels are also cut. This had already happened on the periphery of the eurozone, including in Greece and Ireland, where internal adjustment or devaluation was necessary to try and restore competitiveness.

As critically, in periods of deflation, the price of assets – ranging from equities to property – also declines.

As a consequence, business investment, which has already been lamentable in Germany, also falls. The concern among global forecasters, such as the IMF, is that Europe stands on the edge of a deflationary spiral similar to that which occurred in Japan in the 1990s – and from which that country has never fully recovered.

Fears of deflation in the eurozone are seen as the main threat to global growth in 2015. Many of the leading figures at the IMF,

Mario Draghi has struggled to win support for European-wide quantitative easing

including its Managing Director Christine Lagarde, Chief Economist Olivier Blanchard and the overseer of financial stability, the former Spanish central banker José Viñals, come from eurozone nations. What they say about the region's weak responses to the Great Recession of 2008–10 and subsequent crises among countries in the region cannot be dismissed as the ramblings of those who oppose the single currency.

At the core of the region's difficulties is the failure to deal with the banking crisis in the aftermath of the 2008 panic, when former French President Nicolas Sarkozy saw the crisis as one of Anglo-Saxon capitalism.

ENDEMIC UNEMPLOYMENT

Europe's deepening problems are spelled out in impressive detail in the IMF's October 2014 World Economic Outlook report. Output across the region in 2014 will be 0.8% at best (after two years in negative territory) and 1.3% next year. Even if those figures are achieved, it will do virtually nothing to cure endemic unemployment, currently at 11.2% across the region – and in particular, the high levels of joblessness among the young.

The IMF's Global Financial Stability report tells of a totally dysfunctional European banking system. The Fund warned two years ago of a €200bn black hole in the balance sheets of the major banks. A new IMF survey of 300 banks in the developed world found that a quarter of them, mainly in the eurozone, do not have adequate capital buffers to support lending expansion of 5% a year. In the eurozone, 46% of banks with 60% of the assets are unable to support recovery.

Work on shoring up the banking system in Europe is now in the hands of the ECB. It has recruited the staff, but finds it all but impossible to get the work done. The Bundesbank, a powerful force within the ECB, disputes the whole concept of its role as a bank regulator, arguing that this detracts from its work in managing money, credit and the exchange rate.

This is in stark contrast to the Bank of England and the Federal Reserve, which have both extended their roles as banking regulators in the aftermath of the financial crisis. But few policymakers in Germany, including the Constitutional Court, much like the idea of the country propping up the whole of Europe's broken banking system.

EMERGENCY ASSISTANCE

One of the lessons of the Great Recession is that governments that were willing to put to one side anger at the role of the banks and financiers in the creation of the crisis and move to bail them out and recapitalise them, are those currently showing most progress. Growth in the US for 2015 is forecast at 2.3% and in Britain at 2.7%.

The US and Britain led the way in providing emergency assistance to their banking systems. Among the eurozone nations, Spain and Ireland followed suit –

and both countries are showing some signs of emerging from the danger zone.

Healthy banking systems are critical to functioning economies. Banks supply the credit that is particularly important for the smaller and medium-sized businesses that are the bedrock of all economic systems. They cannot go directly to the money markets in the manner of Siemens, Volkswagen or Danone.

Mario Draghi, the Italian President of the ECB, has struggled to win support for European-wide quantitative easing, the buying of bonds for cash, and has had to opt for second best in his efforts to head off inflation, including the use of negative interest rates. These are intended to make it uneconomic for banks to hold on to excessive deposits and encourage them to lend. It assumes, however, that the banks have sufficient capital buffers to make lending safe.

VOLATILE BONDS

Bonds issued by eurozone countries have been highly volatile since the financial crisis erupted. In 2010, amid fears of a default by Greece and concern about the financial prospects for Europe's periphery, bond yields soared, reaching 8% across much of the region. After fiscal austerity was imposed, confidence grew that the euro would survive and devaluation and default could be averted. American hedge funds, many of them searching for yield,

"The deflationary scenario poses a new era of uncertainty for investors in bonds"

took advantage of the IMF bailouts to invest in eurozone bonds and yields on the periphery tumbled to more normal levels.

The deflationary scenario threatens a new era of uncertainty for investors in the bonds of eurozone countries. Deflation can lead to what economists call the 'liquidity trap.' As the price of goods and assets fall, holding cash and other short-term monetary assets becomes ever more value-accretive. The best investment could be a home safe stuffed with cash.

Bonds will tend to rise in value during periods of deflation since the borrowers (the bond issuers) will expect that when the bond matures or is paid back, it will be at a loss. The money they use to pay back will be worth considerably more than what was borrowed. Yields will tend to fall during inflationary periods in line with low or even negative official interest rates. The combination of falling prices and stagnation also makes default more likely for commercial bonds. Sovereign bonds, backed by governments, should remain safe. However, if there were to be an extended eurozone crisis and the future of the single currency were called into question, then all bets would be off.

At the peak of the Greek crisis in 2010–11, the recommendation of many economists opposing IMF austerity was the adoption of the 'two Ds': devaluation and default. That would be the ultimate nightmare for investors in eurozone bonds.

It would represent the first crack in the unity of the 18-nation eurozone and lead to questions as to whether other peripheral nations would follow suit, causing wild gyrations in financial markets.

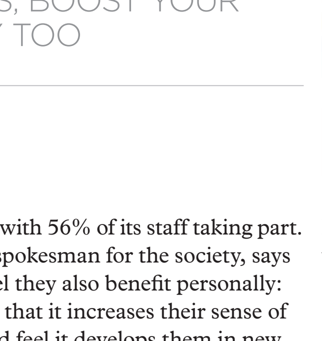
Alex Brummer is City Editor of the **Daily Mail**

Further information
CISI European Regulation Interest Group: sign up at *pfs@cisi.org*

Putting others first

VOLUNTEERING CAN BENEFIT OTHERS, BOOST YOUR CAREER – AND HELP YOUR COMPANY TOO

JILL INSLEY



Getty

A project manager's plan to teach numeracy skills to children at his daughter's primary school has led to a job promotion and a nationwide roll-out for the volunteering scheme he helped design and set up.

Jeremy Beach, who works in the finance department of Nationwide Building Society, came up with the idea of Number Crunching, a programme to support children aged five to seven who are struggling with maths.

"The Nationwide encourages employees to use 14 hours of work time annually for volunteering. As an organiser of a voluntary programme, you are bound to put in more time than that and when we initially set up, I was using lunchtimes and a few hours after work, as well as work time to get things going," he says.

His volunteering has helped struggling mathematicians, but the pupils are not the only beneficiaries. The project has required Beach to interact extensively with senior management at Nationwide, raising his profile and earning him an award from Involve Swindon, an organisation that helps employees volunteer.

"It's improved my CV," he says. "I've been for a few internal employment interviews recently and one of the first things they ask about is Number Crunching."

Volunteering has long been accepted as a way to team build and develop bonds between an employer and its local community and wider public. Nationwide considers it so important that it has committed 74,000 work hours, worth more than £1.3m, to volunteering in the past year, with 56% of its staff taking part. Alan Oliver, spokesman for the society, says volunteers feel they also benefit personally: "They report that it increases their sense of self-worth and feel it develops them in new and different ways."

For those who are considering moving to a different career, seeking promotion or just want to rejuvenate their current role, volunteering can provide an excellent way to gain fresh experience and learn new skills or develop existing ones.

Cheryl Chapman, Director of City Philanthropy, which aims to promote more effective giving among city professionals, says volunteering experience can help an individual stand out at every stage of their career.

She says: "UBS carried out an interesting study that identified how volunteering may deliver tangible career benefits. By comparing the career performance of 250 volunteers against non-volunteers, it found that volunteers performed significantly better.

"Though they can't say there was a causal link, it is likely that those who volunteered had developed the soft skills such as teambuilding, listening, leadership and being more collaborative, that made them better management material, according to UBS."

NETWORKING

Volunteering can provide one of the few opportunities for junior staff to interact with senior managers in a less formal environment and show skills and aptitudes that may remain hidden during the normal working day.

London law firm Allen & Overy runs several volunteering programmes, with opportunities not only open to all members of its 2,000 UK staff but also to those of client firms as well. Some 180 employees and 70 client volunteers took part in the firm's most recent Smart Start Experience, a programme designed to give 17- and 18-year-old students from non-privileged backgrounds the chance to gain insight into the world of business.

Kate Cavelle, Head of Pro Bono and Community Investment for the firm, says: "This helps our lawyers to get to know our clients in a more rounded way, building a broader base to their relationship and enabling them to have conversations that are not just work-related."

"Volunteering experience can help an individual stand out at every stage of their career"

NEW SKILLS

The Smart Start scheme also enables staff to learn new skills and develop existing ones. Allen & Overy surveyed volunteers who have taken part in the scheme, finding that 93% felt they had learned something new about themselves, students or society; 42% said the volunteering experience improved their networking skills; and 40% said Smart Start had improved their confidence.

Sheila Fahy, who specialises in HR and works as a professional support lawyer for Allen & Overy, is accustomed to working

with the elite recruits who are chosen to join this magic circle firm. But the Smart Start scheme has extended her experience.

"Working with students from a wide variety of backgrounds has helped with training by forcing me to tailor to my audience: when you are presenting, you have to pitch to the audience in front of you."

Fahy is a firm believer in volunteering, saying it helps the firm's lawyers become multi-dimensional human beings. "If you are a 'human' lawyer, it makes you a much more approachable lawyer," she adds.

CHANCES OF PROMOTION

Volunteering is an effective way to enhance your CV, improving your employment prospects and chances of promotion. If you are considering a different career, volunteering can help you gain experience in your new area of interest and meet relevant people in that field before you commit yourself to a new job.

Chapman says: "In a job interview, volunteering experience on a CV is a powerful differentiator and great conversation point. Often it shows what you are passionate about and so allows you to showcase yourself in an animated, authentic and memorable way.

"Employers are starting to make the connection between volunteers and leaders. They share the same qualities; they are concerned with issues beyond themselves; they are passionate about the world and moved to take action to improve it; and as a result of volunteering, they build those all-important leadership skills, such as negotiation, collaboration, working with teams and taking responsibility."

A survey carried out by TimeBank through Reed Executive showed that among 200 of the UK's leading businesses:

- 73% of employers would recruit a candidate with volunteering experience over one with none
- 94% of employers believe that volunteering can add to skills
- 58% of employers say that voluntary work experience can actually be more valuable than experience gained in paid employment
- 94% of employees who volunteered to learn new skills had benefited either by getting their first job, improving their salary, or being promoted.

BECOMING A TRUSTEE

If you work in a senior, managerial position, or are aiming for one, you may find volunteering as a trustee is the most rewarding option. Charity trustees serve on the governing body of a charity and are responsible for the general control and management of its administration.

Amy Clarke, who became a trustee of Prime, the Prince's Initiative for Mature Enterprise, five years ago at the age of 37, describes it in an article for the BBC as similar to being an army general.

"They work behind the scenes, they set the strategy, ensure people at the front line have what they need to do their jobs well. But ultimately the buck stops with them," she says. Clarke was working in a full-time job when asked to take on this role, which involved a lot of dedication and, she admits, juggling. "Having a very hectic job means that I have often struggled to meet the time demands placed on me.

"But I have made it work for me and the charity, and the payback has been immense in terms of skills development, networking – and pride. Being a trustee is an opportunity for anyone to broaden their skills sets, regardless of age, and is a great addition to any CV."

Further information

To find out more about becoming a trustee, read the Charity Commission's guide: 'The essential trustee – what you need to know' at *gov.uk/government/publications/the-essential-trustee-what-you-need-to-know-cc3*

WHAT NEXT?

With 161,000 charities and many more organisations such as schools, hospitals, care homes and sports associations needing support, there is no shortage of volunteering opportunities.

However, it is important to make sure both that you have the skills an organisation needs, and that it can provide you with the support you require. *How to Volunteer,* published by the National Council for Voluntary Organisations, provides useful guidelines on identifying the right volunteering opportunity.

Chapman suggests the following tips for selecting an opportunity to volunteer:

- Volunteer in an area you are passionate about – you will be more committed.
- Choose a role where you can use your professional knowledge, skills and expertise.
- Consider how much time you can commit and do not overstretch yourself. You can volunteer for as little as 15 minutes at a time through organisations such as Slivers of Time, while Pilotlight engages with City executives for a few hours a month.
- GoProBono (*goprobono.cityphilanthropy.org.uk/*) is a free searchable database that brings together more than 70 volunteer brokers who can match skilled volunteers with opportunities.

It's important to remember that although volunteering can be a good way to secure the next promotion or career that you have dreamed of, it can be just as – if not more – rewarding simply to give something of yourself to others.

For Fahy, the best volunteering experience has been a trip to Ghana, where she lived alongside Ghanaian families in mud huts with no running water or electricity, and taught in a local school where children had to share pencils.

"I went out there with a mix of Allen & Overy staff including partners and PAs – 75 people over a two-year period – and it was one of the best things I have done in my life."

- Do you have experience of volunteering you'd like to share? Please contact *richard.mitchell@cisi.org*

New ways to manage wealth

HAS THE SHIFT AWAY FROM LONG-TERM, INDIVIDUAL RELATIONSHIPS IN WEALTH MANAGEMENT ADVERSELY AFFECTED THE INDUSTRY?

HEATHER CONNON

At the end of 2003, there were 44 full-service wealth managers with an average of £1,409m investment under management. By the end of 2013, the number of firms had fallen to 36 but their average size had trebled to £4,204m. Business has also become more concentrated among a few firms: the top five full-service wealth managers shared 71.3% of revenue in 2013, up from 65.7% in 2010.

Those statistics, compiled by Compeer, are an indication of the changes the wealth management industry has undergone as it grapples with pressures ranging from a turbulent stock market and the financial crisis to regulatory changes and new technologies. While these changes have accelerated in the last decade as technology has become ubiquitous, the evolution from the traditional business model, under which wealth managers operated in small partnerships or associations of self-employed advisers, to one dominated by large corporate entities with centralised systems and procedures has been going on for much longer – approaching three decades.

Getty

The traditional model of the adviser seeing the same clients throughout their working life, sharing updates over coffee at the client's home, is gradually dying away. Today, a client may communicate with a relationship manager, their affairs may be handled by a range of advisers and their main contact with the firm may be through seminars and online updates. With investment requiring a long-term horizon, how has this shift from long-term, individual relationships to a more corporate, regulated approach affected both advisers and clients?

TRADITIONAL ADVISERS

Some of the more traditional advisers are finding the demise of their old systems hard. One wealth manager, who has been in the industry for 40 years, was a partner in a regional firm of stockbrokers sold five years ago to a European bank. He complains about the bank's rigid structures, which allow him little flexibility in how he communicates with clients and of constraints in how he can invest on their behalf. "I now seem to spend more time completing checklists, ticking boxes and attending internal meetings than on advising clients," he says.

Many of his clients have been with him since the beginning of his career and he has intimate knowledge of their lifestyle, their attitude to risk and their investment objectives, helping him to take an holistic approach to their portfolio. Now, however, he feels the constraints of the firm's investment committee, guidelines on asset allocation and risk assessments force him into a less individual service.

Those representing the corporate side, unsurprisingly, think the industry changes have had little impact on client service. JM Finn & Co offers a case study in the development of private client investment management businesses. Founded almost 70 years ago, it had just four senior partners prior to incorporation in 2006.

"The change in corporate structure has meant an improvement in efficiency"

Five years later, Belgian financial services company Delen Investments acquired a 73% stake and it now has £7.8bn under management for 23,000 clients. Sarah Soar, Head of Investment Management at the firm, says that, if clients had noticed the change at all, it would have been in subtle improvements in customer servicing.

"The change in corporate structure has, in most cases, meant an improvement in service levels and efficiency. What we are

looking to do is to have a more cohesive structure in the way we manage clients' investments. It is possibly not quite as individual as it was in the past, when investment managers were free thinkers who did what they liked with their clients. Now, there is more of an investment process but one which lets the investment manager choose what is best for the client."

Clients seem to concur with the latter view. Research by EY for Compeer found that just a quarter of clients, whether advised or discretionary, thought their adviser ensured their investments were suitable for their needs, and more than half found them good value for money. Few of them had even heard of the Retail Distribution Review and 40% of them said that regulation over the last five years has had no impact at all on their relations with their advisers, while just 11% thought it had had a negative impact, compared with 17% who thought it had been positive.

One area of unhappiness, however, was in the quantity and quality of communication with their wealth managers – almost half thought they should meet their manager at least twice a year, and many expected four meetings or more, something only a minority of the firms provide.

NEW TECHNOLOGIES

That hunger for communication could increase. "Technology now underpins everything people do," says Mark Taylor, Managing Director of Equiniti Investment Services. Just as they use computers, tablets and mobile phones to manage their day-to-day lives, so they want to be able to monitor their wealth managers over a range of different media. "Customer expectations are increasing and that is difficult for wealth managers as they are very traditional. They are having to grapple with regulatory issues, they are having to be more transparent and keep pace with new technologies."

Technology is, however, encouraging the formation of new kinds of wealth management companies. As well as platforms, which are now ubiquitous across the industry, a growing number of companies are using the internet, rather than personal contact, to set up and manage portfolios. Annalise Toberman, who produces the Platforum report, says: "Some providers appear to have come to the conclusion that the market to target now is the less engaged and those with potentially large savings pots but with little or no investment experience." Web-based services like Nutmeg and Money on Toast use questionnaires to assess clients' risk profiles and to suggest individual products that could be suitable.

Equiniti's Taylor expects a continued segmentation of the industry between offerings like these, which use leading-edge technology, and those concentrating more on the high- and ultra-high, net-worth individuals. "The segment which is least well-served is middle England, where banks were big players," he explains, but says firms have been reviewing and restructuring their operations.

RISK PROFILING

Risk profiling has become a core part of the investment process and no one questions the wisdom of tailoring advice to individual circumstances. Platforum's Toberman says: "Relatively few industry figures interviewed question the accepted wisdom around assigning and prioritising a client's risk score in the investment process, but implementation has caused many – the Financial Conduct Authority being no exception – to voice apprehensions about risk profiling and the future outcomes of this process."

JM Finn's Soar says that these tools should offer only a basis for managers to analyse their clients. "If you take two people with a £500,000 portfolio and a medium-risk profile, you can bet that everything else will be different. You need to make sure that what you do is in the interest of each individual client."

The wealth management industry faces yet more changes as pension reforms planned for next year introduce far greater flexibility into retirement planning.

The challenge for the wealth management industry will be to take advantage of those changes to build deeper, and more rewarding, relationships with their clients.

Further information
CISI Wealth Management Professional Forum: sign up at *pfs@cisi.org*

EQUITY RELEASE MAY BE SET FOR FURTHER EXPANSION AS INSURERS, IN PARTICULAR, TAKE A GROWING INTEREST AFTER THE PENSIONS CHANGES

ANDREW DAVIS

Releasing equity

After several years of relative quiet, things are getting lively in the equity release market. Lending in the third quarter of this year reached £375.5m, the biggest quarterly total since records began in 2002 and a year-on-year jump of 32%, according to figures from the Equity Release Council (ERC), the industry association. Lending this year has already topped £1bn, surpassing the 12-month totals recorded from 2009 to 2012. So far in 2014, more than 15,600 over-55s have released equity from their homes, with the average sum taken in Q3 reaching £67,467 – up 9% on the previous three months and 18% on the same quarter in 2013. "We have seen year-on-year increases which are quite dramatic, but from a fairly low base," says Nigel Waterson, Chairman of the ERC. "We're going along at around £1.2bn a year, which is a lot less than the potential. We're not at all complacent, although it's nice to see 34% growth in a year."

EQUITY RELEASE FACTS AND FIGURES

PRODUCT SHARES (H1 2014):

Lump sum 35%

Drawdown 65%

ANNUAL GROWTH IN CUSTOMER NUMBERS BY PRODUCT (H1 2014 vs H1 2013):

Lump sum +16%

Drawdown +13%

AVERAGE EQUITY RELEASED BY PRODUCT (H1 2014 vs H1 2013):

Lump sum £74,896 (up 22% YoY)

Drawdown £57,728 (up 6% YoY)

AVERAGE EQUITY RELEASED BY REGION (H1 2014):

Region	Amount
London	£133,268
South-East	£62,031
South-West	£48,679
East Anglia	£48,218
West Midlands	£39,800
Wales	£37,131
Yorkshire	£36,346
North-West	£35,928
East Midlands	£34,307
Scotland	£36,311
North-East	£33,355
Northern Ireland	£33,025

All figures are from the Equity Release Council

The acceleration is impressive, but as Waterson acknowledges, set against conventional mortgage lending, equity release remains a very small market – around 400,000 mainstream mortgages were approved in the first half of this year, 40 times the number of equity release deals agreed. There are signs, however, that equity release may be set for further expansion as insurers, in particular, take a growing interest. Announcing its half-year results in early August, Legal & General (L&G) said it was looking at launching equity release products, prompted partly by sharp falls in sales of individual annuities after changes to the pensions market in the last Budget.

NO INTEREST

The market L&G is eyeing falls into two main parts in the UK: lump sum and drawdown lifetime mortgages. In both cases, applicants have to be at least 55 and most are a good deal older than that. Both types of product enable a borrower to release a proportion of the equity in their home – on average about 23% – and to pay no interest on the debt during their lifetime. Instead, interest is 'rolled up' and added to the capital with the total repayable when (in the case of a couple) the second borrower either dies or enters residential care, at which point the property will be sold and the outstanding debt cleared. As the names suggest, lump-sum products release a single slice of capital, while drawdown products enable borrowers to take an initial amount and then further sums up to an agreed maximum,

with interest payable only on the amount drawn down.

Interest rates on ERC-approved products are fixed for the duration of the loan and have fallen considerably in recent years as rates more generally have declined – where previously borrowers might have been asked to pay 8%, products today can carry rates closer to 5%. The average paid across the market is currently 6.39%, according to the ERC's autumn 2014 market report.

Equity release is therefore considerably more expensive than the mainstream mortgage market in interest-rate terms. This is because equity release products that meet the ERC criteria incorporate a series of borrower

To protect themselves, lenders restrict the proportion of the value that can be released

guarantees, notably that the total to be repaid will never exceed the sum realised when the property is eventually sold, and that borrowers will have security of tenure as long as they continue to occupy their home. Like annuity providers, equity release lenders must therefore carry the risk that the customer will live longer than expected, resulting in an overall debt that exceeds the ultimate sum realised on the sale. To protect themselves against this risk, lenders restrict the proportion of the property's value that can be released (the percentage can be higher for older applicants) and charge a relatively high rate of interest on their lending.

INDEPENDENT ADVICE

The 'no negative equity' and 'no repossession' guarantees have been important in encouraging the growth of equity release lending, says Waterson. "People are becoming more aware of the protections available. It's a pretty safe product and they're not going to get bamboozled into it." Borrowers must receive independent financial advice and legal sign-off, he adds.

But another major factor recently has been the buoyant performance of house prices, which has naturally increased the supply of equity available for release. Waterson points to estimates that suggest total housing wealth held by people of retirement age could be more than £1trn to illustrate the huge size

Getty

of the potential market for equity release products.

Jane Vass, Head of Public Policy at the charity Age UK, agrees that equity release has plenty of room for expansion. "There seems scope for the market to grow considerably for many years, but it's been very slow to develop," she says.

She also points to shifts in the way equity release is being used that may account for some of the rapid growth in take-up recently. In particular, she says, the use of equity release to clear other debts has become much more common. "That's a market that's increased a lot over the past few years because more people are entering retirement with unpaid debts." Often, the culprit will be an interest-only mortgage that is about to reach full term and has no repayment vehicle in place, although credit card debt is sometimes a factor.

A small but growing number of borrowers are using equity release to fund gifts to children

ERC figures seem to bear this out. The average age at which lump-sum borrowers take out equity release is 68.8 years, suggesting that they need to access their capital fairly soon after retirement. The average age of drawdown customers, who are likely to use the funds more gradually to supplement their income, is now 71.6 years. The ERC figures show that the average age of all equity release borrowers continues to edge upwards, possibly because more people are working past retirement age.

In addition, a small but growing number of borrowers are now using equity release to fund gifts to children and grandchildren, either for property purchases or to clear student debts. In effect, these borrowers are using equity release to provide family inheritances years earlier than they might otherwise arrive.

CAN YOU MOVE HOUSE?

People who have taken out equity release plans are not prevented from moving house and can 'port' their deal to a new property with the agreement of their provider. However, Louise Overton of Essex University points to cases in which borrowers who took out equity release products several years previously later found they could not take the product with them to a purpose-built 'retirement property' because their lender was no longer willing to secure the debt against this type of asset, due to concerns about its likely resale value. "A number of lenders have stopped lending to new customers on retirement properties, but one or two of them have also stopped their existing customers moving to a retirement property," she says.

Under ERC guidelines for advisers, borrowers must be made aware that it may not be possible to port a lifetime mortgage to certain types of property further down the line.

REGULATION

Whether to clear existing debts, supplement income or provide a lump-sum gift to family members, however, it looks as though the decision to choose equity release products is being strongly influenced by another factor: regulation. As part of the reforms in the Mortgage Market Review (MMR), conventional mortgage lenders have tightened their affordability criteria and as a result, it has become much harder for older people to obtain conventional mortgages if the maturity date is beyond the state pension age.

"We're certainly getting regular complaints about that from people who really would be able to afford to mortgage," says Vass. "If people can afford to repay, it seems more sensible to allow them to do that through the standard mortgage market than forcing them into equity release, which, however valuable, is relatively expensive."

It has become much harder for older people to obtain conventional mortgages

Louise Overton, a research fellow at Essex University who focuses on equity release, agrees that the MMR is effectively steering more elderly borrowers into equity release products and she also cautions that it may be restricting scope for product innovation as well. Some recently launched products allow borrowers to service the interest on their loan for a period (thereby reducing the sum that must ultimately be repaid from their estate) before switching into interest 'roll-up' later on. These too, she says, are falling foul of the stricter lending criteria.

"It seems, from tracking advisers' experiences on LinkedIn, that they're trying to arrange these types of plans for their customers and it's being refused on affordability grounds," says Overton. "It looks like that is an unintended consequence of MMR."

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REVIEW OF FINANCIAL MARKETS

RESEARCH INTO WEALTH MANAGEMENT, CAPITAL MARKETS AND BANKING ISSUE 4 DECEMBER 2014

CONTENTS

A revisited version of the cost of capital: the irrelevance of the partial interest tax deductibility on investment and financing decisions - Michele Lizzio, Analyst, Deloitte Financial Advisory, Valuation Services, Milan 2

A quantitative analysis approach to non-performing loan portfolio management: observations from European banks - Michael Widowitz, Principal, The Boston Consulting Group, Frankfurt 8

Derivatives risk management: the importance of understanding correlation - David Moskovic, Exotic and Hybrids Trader, Royal Bank of Scotland 10

EDITORIAL

A seeming paradox I've noticed for some time now is a consensus view that the western banking market is overbanked, with excessive competition and plenty of scope for consolidation, and yet at the same time more 'challenger' banks coming onto the scene than ever before. According to a report last April, the UK Financial Conduct Authority is currently handling 29 banking licence applications, which is by any standard a big number. While plenty of these aspiring banks will be 'niche' players (I'm aware of at least one that is a pure digital bank with no branches and only vanilla products), this suggests that enough sophisticated investors still think the banking sector is worth entering.

I thought of these new up-and-coming banks when reading the summer 2014 issue of *News and Events* from the Holmesdale Building Society. The Chairman's Message at the top of the issue contained the following statement:

"Whilst the banking shake-up over the last few years made it challenging for us, it also created significant opportunities…to provide the service, flexibility [and] focus on customers' interests that are at the heart of the Holmesdale… We will be continuing our traditional 'banking' model, with a focus on fair, simple and helpful products that can be adapted to each individual's needs…"

One could be forgiven for thinking that this is simply platitudes, that every bank makes similar such statements. The trick of course is to really do the above, rather than just say it. And to do that successfully is a mindset, it's a culture that is set from the top down and works to embed the customer service ethos at all levels and all departments of the bank.

But it was another comment from the Holmesdale BS Chairman that really got my attention, when he stated that, as a customer of the institution before he became the Chairman, he "discovered a flexible mortgage process, unlike 'box ticking' national lenders, that would adapt to meet a borrower's needs…the Holmesdale doesn't credit score you, as each mortgage is decided by a real person – someone you can talk to."

At the heart of this approach is the ethos of the local bank, with a genuine understanding of the customer. And I think this is the key to regaining customer trust and confidence, leaving the black box model behind and empowering the local manager to make the lending decision. 'Know your customer' has always been one platitude that actually carries value.

The UK arm of Handelsbanken is another such organisation: it devolves the asset origination authority to the local branch manager, and the success of this firm shows that branch-based banking still has a future.

Irrespective of their intended strategy, operating model and customer franchise, for all 'challenger' banks there is one simple message: if you expect to survive and thrive, you will need to adopt this approach. Genuinely good customer service, and decision-making that is adaptable to local needs, are an imperative.

Of course while such a strategy is necessary, it is by no means sufficient. For the customer to be treated with respect as an individual and not a number, the bank also has to operate internally as an effective team. That means a high quality of management that is expert in the 'soft' skills of leadership and team-building. Too many of the senior executives one meets in this industry are excellent at bureaucracy and process, and implementing the latest consultant-developed HR fad, but lack even the slightest ability to inspire their people. This makes for a turgid atmosphere within the firm, which does nothing for customer service. Challenger banks take note.

In this issue we're pleased to bring you yet again three diverse but very topical articles on different aspects of the markets. Don't let the maths in Mr Lizzio's paper put you off, he makes a very valid and practically worthwhile observation about the non-applicability of the tax benefit of orthodox corporate finance theory, as originally put forward by Modigliani and Miller. Firms looking to optimise their capital structure need to look less at tax benefits and more at what makes sense from a conservative balance sheet management perspective. Depending on one's jurisdiction, there is something of genuine insight here.

One would not be surprised to learn that in the post-2008 economic environment the level of non-performing loans (NPLs) in the asset portfolios of European banks has been increasing. Michael Widowitz writes about the need to deploy more effective data analytics capability if one is to manage NPL portfolios more effectively, and this paper is required reading for any corporate banker.

Our final paper is something of a 'learning curve' piece for all firms that use derivatives, be they banks or institutional investors. Too often those turning to derivatives to hedge structural balance sheet risk are not aware of the correlation effects on derivative valuation, and this piece is an accessibly written attempt to plug this gap.

Enjoy the issue.

Professor Moorad Choudhry FCSI, Editor

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A REVISITED VERSION OF THE COST OF CAPITAL: THE IRRELEVANCE OF THE PARTIAL INTEREST TAX DEDUCTIBILITY ON INVESTMENT AND FINANCING DECISIONS

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ABSTRACT

The *purpose* of this paper is to investigate the interest tax deductibility effect on cost of capital under *earning stripping rules* recalling Modigliani-Miller's theorem (1958, 1963). In fact, Italy's corporate taxation, as other countries, does not allow to fully deduct interest expenses of debt but it imposes a threshold by linking the interest tax deductibility to the ebitda driver. This limit could reduce the tax shield benefit for firms with higher financial leverage, creating a misconception about optimal capital structure and firm value.

The findings have led to an adjustment of the weighted average cost of capital (WACC) formula analysing the single and multi-period analysis by which in both cases the limitation is irrelevant in terms of optimal capital structure decision and firm value.

SECTION I: INTRODUCTION

In 1958, Modigliani and Miller made an important contribution to the financial community, developing assumptions about *financing* behaviour. In their classic article they showed the first proposition, known as '*Irrelevance Proposition*', in which, in perfect capital markets without taxes and transaction costs, the capital structure choice does not affect firm value. In the second proposition, reinforced in the '*Tax Correction article*' (1963), they argued that the firm value is not independent from the capital structure, which any tax-paying corporation gains by borrowing, that is, the greater the marginal tax rate, the greater the gain (Myers 1984).

Other authors interpreted the capital structure; for instance, Miller (1977) asserted that tax benefit is overstated if we do not consider the personal income taxation. Another important contribution comes from Kraus and Litzenberger (1973), concluding that in a firm with increasing leverage the tax shield advantage is compensated by increased probability of default, or by enhancing *bankruptcy* costs. Thus, additional leverage adds value until the value of tax shields matches bankruptcy costs.

However, the borrowing does not depend only on the tax benefit but also on the ability to cater for the different interests between management and shareholders. In this sense, Jensen (1986) called it '*control hypothesis*' which represents the threat that not being able to repay debt makes the management more disciplined and more credible than if they promise future cash return to shareholders (*dividends* or *stock buy-backs*).

SECTION II: THE EFFECT OF CAPITAL STRUCTURE ON FIRM VALUE UNDER FULL-DEDUCTIBILITY (FD) HYPOTHESIS

Back to Modigliani and Miller's theory, in a valuation with taxes the cost of capital seems unaffected by the change of debt, therefore any benefits substituting cheaper debt for more expensive equity are offset by increases in both their costs (Damodaran 2010)[2]. However, empirical evidence shows the existence of the optimal capital structure for which the benefit of debt may be greater than cost of debt.

Moreover, the optimal capital structure is not equal for any firm, but it is influenced in several aspects as:

- *marginal tax rate*: the level of tax rate determines the level of tax advantage;
- *deductibility*: the level of tax benefit depends on the degree of interest tax deduction;
- *type of firm*: the type of firm is a crucial element which determines the capability to raise debt and repay it according to the variability of cash flows;
- *flexibility*: the excess of debt reduces the financial flexibility;
- *cost of debt and credit crunch*: the cost of debt and availability of resources depend also on macro-economic factors, that can make it more difficult to reach the target capital structure;
- *agency costs*: the greater the separation between management and shareholders, the greater the need for *debt discipline*.

At the basis of Modigliani and Miller's propositions, the central role is given to the after taxes operating profit, which represents an uncertain stream. In fact, the volatility in operating earning is related to both, the capability to cover interest payments and tax advantage. Differently, according to Modigliani and Miller (1963), the tax shield is a certain flow[3]. However, this is not always true because the tax shield benefit is tightly linked to the level of ebit. For instance, negative ebit could reduce, possibly substantially, any benefits from interest tax shield (Miller 1988). Consequently, according to Modigliani and Miller's theorem, the value of a firm in a world with taxes is equal to the following formula:

$$V_L = \frac{NOPAT}{WACC} = \frac{EBIT(1 - t_c)}{K_{EU}} + \frac{It_c}{K_D} \tag{1}$$

where V_L is the value for a levered firm, *NOPAT* is the net operating profit after taxes, *WACC* is the cost of capital, *EBIT* is the earning before interest and taxes, t_c is the corporate tax rate, K_{EU} is the unlevered cost of equity, I are interest expenses on debt and K_D is the cost of debt[4].

Thus, after these academic underpinnings, the example about the optimal capital structure under full-deductibility hypothesis is based on the following assumptions[5]:

- we reject the hypothesis of *perfect capital markets* where financing decisions affect firm value;
- we suppose ten scenarios with a different debt ratio. We also suppose the ability of the company to borrow and raise debt until the last scenario with a maximum weight of debt of 90%;
- we suppose that in each scenario the cost of debt is refinanced at the new cost of debt rate;

1 *The author acknowledges the helpful contribution of Giorgio Luraschi (Senior Analyst at Deloitte Financial Advisory – Valuation Services – Milan Office) and Andrea Gallucci (Bocconi University). This paper is dedicated to Professor Alberto Falini and another Professor of Finance who believed in my career.*

2 *As introduced, the assumptions are valid in perfect capital markets where a firm's financing decisions have no effect on its market value and its financing decisions have no consequence to its security holders (Fama 1978).*

3 *The condition is satisfied with two requirements: first, the tax shield is always obtained through taxable income and when the latter is negative it should be carried backward or forward; second, the tax rate must remain the same. Differently, according to Miles and Ezzell (1980, 1985), since the future asset value is uncertain, then the value of tax shields is also uncertain.*

4 *In this case the ebit is assimilated as a cash flow before taxes.*

5 *All values are assumed in euro currency.*

- the cost of debt increases as the leverage enhances[6];
- the ebitda and ebit are equal for each scenario;
- the marginal tax rate is the same for each scenario[7];
- the interest expenses on debt are fully tax deductible;
- we do not consider interest income on cash.

Therefore, starting with the single-period analysis, the example assumes for each scenario an ebitda equal to 140, an ebit equal to 110 and a NOPAT equal to 80. The balance sheet considers an enterprise value equal to 1000. Table 1 shows the results from the analysis. The K_{EU} (unlevered cost of equity) is obviously the same in every scenario. Conversely, a greater leverage causes an increased K_{EL} (levered cost of equity). With these assumptions WACC and firm value are respectively minimised and maximised in the fifth scenario (debt ratio of 40%) with a value of 2,195[8].

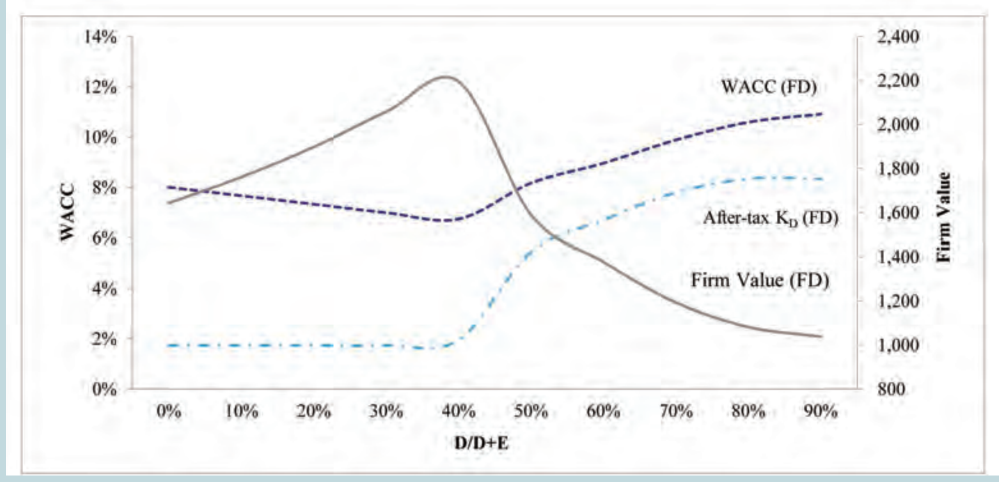
The multi-period analysis is related to the Myers' assertion (1984), defined *static trade-off* framework, that is, supposing to substitute debt for equity until the firm value is maximised and maintain the leverage on hedge of the asset life. Thus, the firm value is determined considering every scenario as a future year of the overall time horizon. Discounting the cash flows at the same WACC used in the single-period analysis, the present value is equal to 517[9]. See Table 1 below.

Table 1 Cost of capital and firm value under full-deductibility hypothesis.

Full Deductibility Hypothesis										
Scenario	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
D/D+E	0%	10%	20%	30%	40%	50%	60%	70%	80%	90%
K_{EU}	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
K_{EL}	8.0%	8.3%	8.7%	9.2%	9.9%	10.9%	12.4%	14.8%	19.6%	34.1%
After-tax K_D (FD)	1.7%	1.7%	1.7%	1.7%	2.0%	5.4%	6.7%	7.8%	8.3%	8.3%
WACC (FD)	**8.0%**	**7.7%**	**7.3%**	**7.0%**	**6.7%**	**8.2%**	**9.0%**	**9.9%**	**10.6%**	**10.9%**
Interest Tax Deductible	0	2.4	4.8	7.2	10.8	37.5	55.5	75.3	92.0	103.5
Marginal Tax Rate	27.5%	27.5%	27.5%	27.5%	27.5%	27.5%	27.5%	27.5%	27.5%	27.5%
Value of Tax Shields	**0**	**0.7**	**1.3**	**2.0**	**3.0**	**10.3**	**15.3**	**20.7**	**25.3**	**28.5**
Firm Value (FD)	**1,643**	**1,761**	**1,898**	**2,058**	**2,195**	**1,589**	**1,377**	**1,193**	**1,082**	**1,038**
Firm Value as *PV of Cash Flows* (FD)					**517**					

Source: Personal elaboration.

Figure 1 WACC, debt ratio and firm value.



Source: Personal elaboration.

6 *As we know, the rating is attributed by considering quantitative and qualitative elements. In this case, we simply determine the rating and spread on debt by adopting the interest coverage ratio which is strictly linked to the level of ebit. However, it creates a circular reasoning in calculating the cost of debt because it needs the spread on debt, and consequently, the spread on debt needs the rating, determined from the level of interest expenses to ebit.*

7 *We refer to the corporate income tax for Italy equal to 27.5%.*

8 *The firm value is calculated through the DCF model in hypothesis of stable growth firm as follows: Firm value =* $\frac{\text{NOPAT}\ (1+g)}{\text{WACC}-g}$ *, where g is assumed 3%.*

9 *In this analysis, the firm value is the present value of expected cash flows (ten periods) calculated as follows:* $\sum_{t=1}^{10} \frac{\text{NOPAT}_t}{(1+\text{WACC})^t}$.

SECTION III: THE EFFECT OF CAPITAL STRUCTURE ON FIRM VALUE UNDER PARTIAL-DEDUCTIBILITY (PD) HYPOTHESIS

This section shows the effect of the partial interest deductibility on financing and investment decisions under current Italian legislation, which allows deduction of net interest[10] at the limit of 30% on ebitda, with the excess not deductible. However, there are several issues that match this disadvantage; for instance, the excess of ebitda capacity[11] on net interests can be carried forward unlimited for future tax periods. This characteristic creates doubts and misconceptions about what the effect is in terms of *value added*. In a better way, the *unlevered DCF model*, as used in the prior example, highlights the advantage to borrow from the minimisation of WACC. Thus, usually the WACC is applied adopting the marginal tax rate without considering the partial interest tax deductibility. This carelessness does not create any difference below the threshold; after that, the tax shield into WACC formula does not reflect the required return, overestimating the firm value.

A. Single-period analysis

In the single-period analysis, we consider the same assumptions adopted in Section II. Conversely, we edit the WACC by taking into account the lower tax benefit on cost of debt. In fact, the tax shield on debt is steady while the corporate income tax decreases as the leverage increases. Thus, since the deductibility is not a simple percentage on cost of debt but it is linked to the size of ebitda and interest expenses, this means that there is not a static way to correct the WACC and in numerical terms it changes firm by firm. In other words, the WACC formula should be modified for a lower tax advantage through the following tax rate formulas:

First formula

The first formula suggests the adjusted tax rate for K_D as the ratio between T_{FD} and π_{PD}, where $t_{c(adj)}$ is the adjusted tax rate for K_D, t_c is the corporate tax rate, π_{PD} and π_{FD} are respectively the taxable income under partial and full-deductibility hypothesis, T_{PD} and T_{FD} are respectively the taxes paid under partial and full-deductibility hypothesis, I_{PD} and I_{FD} are respectively the interest tax deductible under partial and full-deductibility hypothesis, *TSL* is the tax shield lost and *I* or *rD* are the interest expenses.

While for the numerator the marginal tax rate is multiplied by the taxable income, under the full-deductibility hypothesis, where it is the difference between ebit and interest expenses, the denominator (which is the taxable income under partial-deductibility hypothesis) is the result between ebit and the minimum of the limit of 30% on ebitda and interest expenses on debt. In other words, before the limit the function considers all interest expenses; when the limit is overcome the interest tax deductibility is limited to 30% of ebitda:

$$t_{c(adj)} = \frac{t_c[\text{ebit} - rD]}{\text{ebit} - [\min(0.3\text{ebitda}; rD)]} = \frac{t_c \pi_{FD}}{\text{ebit} - I_{PD}} = \frac{T_{FD}}{\pi_{PD}}$$

Or equivalently, at numerator the taxes paid under full-deductibility hypothesis are equal to the taxes paid under partial-deductibility hypothesis less the difference between the value of tax shields in both hypotheses:

$$= \frac{T_{PD} - t_c(I_{FD} - I_{PD})}{\pi_{PD}} = \frac{T_{PD} - [(t_c I_{PD}) - (t_c I_{FD})]}{\pi_{PD}}$$

that is, for a given level of debt, the adjusted tax rate for K_D is the ratio between the taxes paid under partial-deductibility hypothesis less the tax shield lost and taxable income under partial-deductibility hypothesis. Consequently, the marginal tax rate is adjusted by the ratio between tax shield lost and taxable income under partial-deductibility hypothesis:

$$= \frac{T_{PD} - TSL}{\pi_{PD}} = \frac{T_{PD}}{\pi_{PD}} - \frac{TSL}{\pi_{PD}} = t_c - \frac{TSL}{\pi_{PD}} \tag{2}$$

Second formula

The second formula is obtained through the one proposed by Damodaran (2010) when interest expenses are greater than operating income. In fact, the formula is defined as the ratio between *MTS* (maximum tax shield) and *I* (interest expenses):

$$t_{c(adj)} = \frac{MTS}{I} \tag{3}$$

where the MTS is the tax benefit from the interest tax deduction obtainable under partial-deductibility hypothesis as follows:

$$MTS = \min(0.3\text{ebitda}; rD)t_c \tag{4}$$

In this formula, the marginal tax rate is proportionally adjusted by the ratio of maximum interest tax deductible to interest expenses, defined as *α* (Deductibility Interest Factor):

$$t_{c(adj)} = \frac{\min(0.3\text{ebitda}; rD)}{rD} t_c = \frac{I_{PD}}{I} t_c = \alpha t_c \tag{5}$$

Empirically, both formulations give the same effect, decreasing the marginal tax rate as interest expenses become not fully deductible. Thus, a reduction of tax rate, and hence, a loss of tax shields, implies a greater cost of capital than the one exposed in Section II, making inevitable the adjustments.

First of all, if the *comparable method*[12] for beta calculation has been used, the adjustment should be made on cost of equity through the Hamada's formula (1969):

$$K_{EL} = R_F + (R_M - R_F)\beta_L \tag{6}$$

where the levered beta is equal to:

$$\beta_L = \beta_U \left[1 + \left(1 - t_{c(adj)}\right)\frac{D}{E}\right] \tag{7}$$

Secondly, the tax rate adjustment is implemented into WACC[13] formula:

$$WACC = K_{EL}\frac{E}{D+E} + K_{D(adj)}\frac{D}{D+E} \tag{8}$$

where the after-tax cost of debt is calculated as follows:

$$K_{D(adj)} = \text{pre-tax } K_D(1 - \alpha t_c) = \text{pre-tax } K_D\left(1 - t_{c(adj)}\right) \tag{9}$$

Back to the example, the central point is the loss of tax shields after the

10 *Net of interest income on cash.*

11 *When net interest expenses are lower than limit (0.3ebitda).*

12 *The* comparable method *extracts the unlevered or asset beta from comparable firms or industry average and it is adjusted for the different degree of financial leverage and marginal tax rate. The adjustment on beta is not useful if other methods have been used, such as* regression method, *unless the degree of financial leverage of the company is changed.*

13 *D = Debt, E = Equity, $ß_L$ = Levered Beta, $ß_U$ = Unlevered Beta, R_F = Risk Free Rate, R_M = Market Return.*

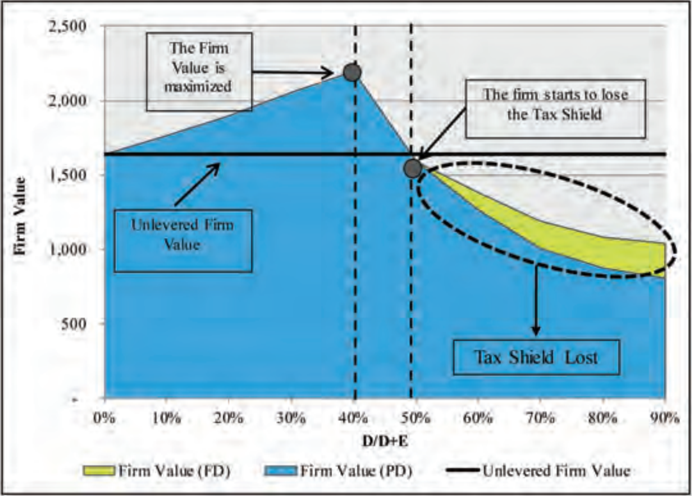
threshold in which, as Table 2, after the sixth scenario there is a difference between partial and full deductibility. This difference is due to lower interest tax deductible under partial-deductibility hypothesis.

In fact, while in the case of full deductibility the tax shield increases until the tenth scenario with a value of 28.5, in the partial deductibility, the tax shield becomes flat once it exceeds the limit, maintaining a steady value of 11.6. Therefore, because the tax shield does not follow the growth of debt, this confirms the inclusion of the tax-rate adjustment into WACC formula[14]. See Table 2 below.

Observing Table 2, the tax-rate adjustment creates differences after the sixth scenario for the following *key-drivers*: the K_{EU} (unlevered cost of equity) is the same because it is not influenced from the capital structure; differently, the higher cost of debt due to lower marginal tax rate makes the K_{EL} (levered cost of equity) and *WACC* more expensive. For instance, in the seventh scenario the WACC under full deductibility is equal to 8.96% while in this case it is equal to 9.50%.

What is the effect of the partial-interest deductibility on firm value? Comparing the two hypotheses, that is, full and partial deductibility, the evidence is that after the limit there is a loss of tax shields, and hence, of firm value[15]. This means that a firm with a higher degree of financial leverage will have a lower value. In fact, after the sixth scenario we find a different firm value, with the largest gap in the tenth scenario (806 for the partial deductibility, 1,038 for the full deductibility). However, as Figure 2 shows, because the capital structure is maximised at the same point in both hypotheses (debt ratio of 30% and 40%), and since until the sixth scenario there is no difference between partial and full deductibility in terms of tax shield and firm value, this proves that the partial deductibility does not influence the optimal capital structure choice, that is, it is irrelevant[16].

Figure 2 Firm value under partial and full-deductibility hypothesis.



Source: Personal elaboration.

Numerically, the best capital structure choice is in the fifth scenario with a value of 2,195.

LEMMA 1: *In the single-period analysis the optimal capital structure is at the same point for both hypotheses which is always before the loss of tax shields. After the limit, higher financial leverage determines a loss of value.*

Proof: If interest expenses under partial deductibility hypothesis are less or equal than maximum interest tax deductible, that is:

$$rD \leq 0.3ebitda \tag{10}$$

Table 2 Cost of capital and firm value under partial-deductibility hypothesis (single-period analysis).

Partial Deductibility Hypothesis - Single Period Analysis										
Scenario	1	2	3	4	5	6	7	8	9	10
D/D+E	0%	10%	20%	30%	40%	50%	60%	70%	80%	90%
K_{EU}	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
K_{EL}	8.0%	8.3%	8.7%	9.2%	9.9%	10.9%	12.8%	15.9%	22.0%	40.0%
After-tax K_D (PD)	1.7%	1.7%	1.7%	1.7%	2.0%	5.4%	7.3%	9.1%	10.1%	10.2%
WACC (PD)	**8.0%**	**7.7%**	**7.3%**	**7.0%**	**6.7%**	**8.2%**	**9.5%**	**11.1%**	**12.4%**	**13.2%**
Interest expenses [rD]	0	2.4	4.8	7.2	10.8	37.5	55.5	75.3	92.0	103.5
Maximum Interest Tax Deductible [30%EBITDA]	42.0	42.0	42.0	42.0	42.0	42.0	42.0	42.0	42.0	42.0
Interest Tax Deductible (IPD) [min(0.3ebitda;rD)]	**0**	**2.4**	**4.8**	**7.2**	**10.8**	**37.5**	**42.0**	**42.0**	**42.0**	**42.0**
Value of Tax Shields (PD)	0	0.7	1.3	2.0	3.0	10.3	**11.6**	**11.6**	**11.6**	**11.6**
Marginal Tax Benefit (PD)	0	0.7	0.7	0.7	1.0	7.3	1.2	0.0	0.0	0.0
Value of Tax Shields (FD)	0	0.7	1.3	2.0	3.0	10.3	**15.3**	**20.7**	**25.3**	**28.5**
Marginal Tax Benefit (FD)	0	0.7	0.7	0.7	1.0	7.3	5.0	5.4	4.6	3.2
Tax Shield Lost	**0**	**0**	**0**	**0**	**0**	**0**	**-3.7**	**-9.1**	**-13.8**	**-16.9**
Firm Value (FD)	**1,643**	**1,761**	**1,898**	**2,058**	**2,195**	**1,589**	**1,377**	**1,193**	**1,082**	**1,038**
Firm Value (PD)	**1,643**	**1,761**	**1,898**	**2,058**	**2,195**	**1,589**	**1,265**	**1,009**	**870**	**806**

Source: Personal elaboration.

14 *The tax rate adjustment is fundamental in order to underline the loss of value. In this sense, Fernández and Bilan (2007) advise not to use the statutory tax rate (marginal tax rate) in a levered company but the effective tax rate which is related to the cash flows.*

15 *In Appendix 2, Figure 3 shows the loss of tax shields.*

16 *See Table 4, Appendix 2.*

there is not a loss of tax shields because the value of interest expenses under partial deductibility hypothesis is the same as the one under full deductibility hypothesis:

$$\mathrm{TSL} = 0, \text{ when } \alpha = \frac{I_{PD}}{I} = 100\% \tag{11}$$

that is, the taxes paid and taxable income are the same in both hypotheses as the first formula (2):

$$t_{c(adj)} = \frac{T_{PD} - TSL}{\pi_{PD}} = \frac{T_{PD}}{\pi_{PD}} = \frac{T_{FD}}{\pi_{FD}} = t_c \tag{12}$$

and second formula (5), with α of 100%:

$$t_{c(adj)} = \alpha t_c = t_c \tag{13}$$

therefore, because the optimal capital structure is always maximised before the limit, the two hypotheses have the same corporate tax rate and WACC:

$$WACC_{PD} = WACC_{FD} \tag{14}$$

or, the firm value under partial deductibility hypothesis is maximised at the same point of the firm value under full deductibility hypothesis.

$$maxV_{PD} = maxV_{FD} \tag{15}$$

Moreover, as Figure 2 shows, in this case the loss of tax shields is at the point at which the firm value in both hypotheses, partial and full deductibility, is lower than the one under *all equity financing*. This means that in both cases it should be favourable for an investor to shift wealth from debt to equity, making the partial interest deductibility *irrelevant* in terms of financing decisions.

B. Multi-period analysis

As shown in Section II, we determine the firm value in the multi-period analysis supposing every scenario *t* as a future year. Therefore, the purpose of this section is to investigate the impact of the partial-interest deductibility for which the firm value is defined as the present value of expected cash flows.

As exposed in the introduction of Section III, the art. 96 allows to carry forward the excess of ebitda and hence to recover the loss of tax shields for years when the interest expenses will overcome the limit (30% ebitda).

The excess of ebitda is defined as the difference between *maximum interest tax deductible* (30% ebitda) and *interest expenses*. If interest expenses are less than limit (30% ebitda), the excess of ebitda is positive and its accumulation allows to create the Deductibility Interest Reserve (DIR). For instance, looking at Table 3, in the sixth scenario (year) the excess of ebitda is 4.5, as the difference between 42 and 37.5.

Therefore, between the first and sixth year, the excess of ebitda allows an increase in the DIR when, after the sixth scenario, the interest expenses will be greater than maximum interest tax deductible[17]. In fact, after the sixth year the DIR is equal to 189[18] and allows to recover *cum-γ* (cumulated interest amount for full deductibility) equal to 158[19], giving the same result of the full deductibility hypothesis. In fact, the present value is the same as the one obtained under full deductibility hypothesis (see Table 1) equal to 517.

Table 3 Cost of capital and firm value under partial-deductibility hypothesis (multi-period analysis)

Partial Deductibility Hypothesis - Multi Period Analysis

Scenario	1	2	3	4	5	6	7	8	9	10
D/D+E	0%	10%	20%	30%	40%	50%	60%	70%	80%	90%
K_{EU}	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
K_{EL}	8.0%	8.3%	8.7%	9.2%	9.9%	10.9%	12.4%	14.8%	19.6%	34.1%
After-tax K_D (PD)	1.7%	1.7%	1.7%	1.7%	2.0%	5.4%	6.7%	7.8%	8.3%	8.3%
WACC (PD)	**8.0%**	**7.7%**	**7.3%**	**7.0%**	**6.7%**	**8.2%**	**9.0%**	**9.9%**	**10.6%**	**10.9%**
Interest expenses [rD]	0	2.4	4.8	7.2	10.8	37.5	55.5	75.3	92.0	103.5
Maximum Interest Tax Deductible [30%EBITDA]	42.0	42.0	42.0	42.0	42.0	42.0	42.0	42.0	42.0	42.0
EBITDA excess	**42.0**	**39.6**	**37.2**	**34.8**	**31.2**	**4.5**	**0**	**0**	**0**	**0**
γ	**0**	**0**	**0**	**0**	**0**	**0**	**13.5**	**33.3**	**50.0**	**61.5**
Interest expenses [rD]	0	2.4	4.8	7.2	10.8	37.5	55.5	75.3	92.0	103.5
Interest Tax Deductible [IPD without DIR]	0	2.4	4.8	7.2	10.8	37.5	42.0	42.0	42.0	42.0
Interest Tax Deductible [IPD with DIR]	0	2.4	4.8	7.2	10.8	37.5	55.5	75.3	92.0	103.5
Taxable Income	110.0	107.6	105.2	102.8	99.2	72.5	54.5	34.8	18.0	6.5
Adjusted Marginal Tax Rate	**27.5%**	**27.5%**	**27.5%**	**27.5%**	**27.5%**	**27.5%**	**27.5%**	**27.5%**	**27.5%**	**27.5%**
Firm Value as *PV of Cash Flows* (PD)					**517**					

Source: Personal elaboration.

17 *In that case the excess of ebitda is negative and assumed equal to zero.*

18 *189 (DIR) is the result of 42+39.6+37.2+34.8+31.2+4.5 (rounded).*

19 γ *is the difference between* interest expenses *and* maximum interest tax deductible. *For instance, at year seventh γ is 13.5 and represents the amount required in order to obtain the full deductibility at that year. 158 (cum-γ) is the result of 13.5+33.3+50+61.5 (rounded).*

LEMMA 2: *In the multi-period analysis the full interest deductibility is obtained if the DIR is greater or equal to cum-γ.*

Proof. If interest expenses at period *t* are greater than maximum interest tax deductible:

$$I_t > 0.3\text{ebitda}_t$$

t=1…10 (16)

and if the DIR is enough to save the full interest deductibility:

$$\text{DIR} \geq \text{cum-}\gamma \quad (17)$$

where cum-γ is the cumulated value of:

$$\gamma_t = I_t - 0.3\text{ebitda}_t$$

t=1…10 (18)

then, the loss of tax shields is nil because in both hypotheses we have the same amount of interest tax deductible:

$$\text{TSL}_t = 0, \text{ when } I_{FD} = I_{PD(\text{without DIR})} + \gamma = I_{PD(\text{with DIR})}$$

t=1…10 (19)

therefore, as in Table 3, the marginal tax rate does not change (27.5%) and the cost of capital is the same than the one used under full deductibility hypothesis:

$$\text{WACC}_{PD} = \text{WACC}_{FD} \quad (20)$$

consequently, we obtain the same present value of cash flows in which the partial deductibility does not affect financing and investment decisions, or else, it is irrelevant.

$$\text{PV of cash flows}_{PD} = \text{PV of cash flows}_{FD} \quad (21)$$

CONCLUSION

Concluding, in corporate investment and financing decisions it is necessary to know the financial leverage effect on value. The art. 96 may give a disadvantage making it helpful to adjust the WACC with a lower marginal tax rate. However, the effect may be different between single period and multi-period analysis in terms of optimal capital structure decision and firm value.

In the *single-period* analysis, the proof shows that optimal capital structure choice is not influenced from the application of the rule, but it affects the value when the interest threshold is overcome, making fundamental adjustments on tax rate and WACC; otherwise, the firm is *overvalued*.

In the *multi-period* analysis, the firm value is the same in both hypotheses only when the DIR is equal or greater than cum-γ. Conversely, if the DIR is not capacious and the WACC is not adjusted, the firm is still *overvalued*.

Therefore, since each firm has different characteristics in terms of *cash flows, risk* and *growth*, it is advisable to implement the formulation in order not to overstate the firm.

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A QUANTITATIVE ANALYSIS APPROACH TO NON-PERFORMING LOAN PORTFOLIO MANAGEMENT: OBSERVATIONS FROM EUROPEAN BANKS

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ABSTRACT

In order to improve their credit risk management practices, European banks are moving towards an optimised approach towards their non-performing loan (NPL) books. Quantitative analysis can help significantly in this process, supporting the NPL management in various dimensions. Early-warning patterns enable bank risk managers to take mitigating actions before risks materialise, an increased automation of processes reduces administrative cost, and portfolio management tools help to select client clusters that are in line with the bank's overall risk strategy. Introducing quantitative analytics instruments into the day-to-day business has shown in several case examples to significantly increase the value derived from problematic portfolios and thus plays an important role in post-crisis management of banks' credit portfolios.

NPL management has become a significant balance sheet management factor for European banks, since their incidence has risen inexorably above pre-crisis levels. In the eurozone alone, the share of NPLs in total gross loans in 2013 has risen to 6.9%, up from 4.6% back in 2009. These numbers are partly driven by the more distressed countries within the eurozone (Cyprus, Greece, Spain, Portugal), but also by Central and Eastern Europe countries such as Hungary (17% NPL), Lithuania (12% NPL), Romania (22% NPL), or Slovenia (13% NPL). In total, currently banks in the eurozone have over one €1trillion (€million million) in NPL assets on their balance sheets, including €290 billion in Italy, €210 billion in Spain, and €170 billion in France.

PROTECTION AGAINST CRISES REQUIRES STRINGENT NPL MANAGEMENT

As the current economic outlook is still dominated by insecurity and fear of a rebound of the crisis, it is worthwhile to observe the link between macroeconomic vulnerabilities and the development of banks' NPL portfolios. As pointed out in Mwanza Nkusu's IMF Working Paper on the subject[1], the NPL ratio is – as a general trend – positively affected by real GDP growth, growth in equity prices or increase in house prices, while on the other hand it is negatively impacted by a rising unemployment rate. These observations are in line with the 2013 ECB working paper on NPL and the economic cycle[2], which also highlights the effect of foreign exchange rate fluctuations (depreciations) as a factor increasing NPL ratios.

Based on these observations, we conclude that economic crises are expected to drive the NPL ratio in banks' loan books. On the other hand, we observe increasing pressure on banks to become more stress-resilient, as evidenced by the ECB's comprehensive assessment exercise and regularly recurring stress tests. We believe that banks seeking to prepare for future crises and stress tests will need to improve their NPL management practices accordingly, as "*sitting on NPLs makes a bank far more vulnerable*"[3].

In this paper, we present a quantitative decision-making process with which banks can actively manage their NPL performance. We have seen these elements applied by a number of banks in practice, and believe that the improvement in banks' NPL management processes that results will be a key competitive advantage going forward.

ELEMENTS OF A BEST PRACTICE APPROACH FOR NPL MANAGEMENT

In building a best practice collection and NPL management function, we believe in three success principles: Standardised and automated processes, a data-driven decision support with a high degree of underlying quantitative analysis, and specific tailoring to the bank's overall risk strategy. These principles should be applied across the entire value chain, starting already at the level of the performing loan portfolio.

Introducing **standardised and automated processes** primarily aims at avoiding case-specific loops and potentially inconsistent individual decision making. It involves:

- defining clear handover and escalation criteria to collection/workout/intensive care units (and potentially back to the performing loan book, once the position has recovered)
- stringent process definitions and centralised process control with a short time to market of steering impulses, and
- a client-oriented collection process with incentives for (client) co-operation.

Quantitative analysis helps make the decision processes faster and more objective. Specifically, banks should:

- establish early-warning-systems and risk heatmaps already at the level of the performing portfolio, so that they can anticipate potential difficulties
- establish portfolio monitoring systems including regular analysis of collection buckets (performing vs. watch vs. past due etc.) as well as roll rates (time-over-time migrations between buckets)
- define and implement quantitative decision support tools including cash flow projections and NPV calculations simulating different possible actions, and
- systematically record data on success/failure after taken actions to serve as input data for future fine-tuning of the algorithms.

Banks will need to **tailor systems to their needs**, especially to their risk strategy. For example, they need to consciously decide the trade-off between NPL book size vs. P&L burden of loan loss provisions. Furthermore, banks benefit when they manage to set up flexible systems – being able to adapt quickly to a new strategy and making sure that new directions get implement rapidly and change the behaviour of workout employees.

As another example, reputational risks are difficult to quantify but need to be factored in as well. The more specific the bank's risk strategy is defined, the easier it is to establish a collection logic which goes beyond simple recovery maximisation.

Two recent case studies of our project work illustrate how quantitative decision-making support together with the right systems and processes can tangibly alter the performance of NPL portfolios:

1 *IMF Working Paper 'Nonperforming Loans and Macrofinancial Vulnerabilities in Advanced Economies', Mwanza Nkusu, July 2011*

2 *ECB Working Paper Series 'Non-Performing Loans – What Matters in Addition to the Economic Cycle?', Roland Beck, Petr Jakubik and Anamaria Piloiu, February 2013*

3 *Risk magazine 'Stress tests prompt NPL rethink', Joe Rennison, May 2014*

Case study 1: High importance of early warning systems

Similar to successful soccer teams, where successful defence starts already at the level of the attackers, successful NPL management has to start already with the management of the performing parts of the portfolio. Essentially, being the first to know increases the probability of successful recovery in comparison to other creditors. Quantitative analysis of past NPL migrations can uncover patterns which help detect similar migrations. In a typical scoring model, financial and non-financial information on the client (which needs to be actively collected leveraging the client relationship) get connected, which generates new insight on the specific client situation and can help to identify potential defaults well in advance (see Figure 1). As an example, variances in the booking date of periodic inflows or a switch of automatic direct debits to manual cash transfers can indicate a worsening of the client's financial condition.

Building such a scoring model depends heavily on supply of behavioural information (current account, external payment experience), which implies accordingly that processes for the collection and systematisation of such information need to be established.

Case study 2: Non-performing loan strategy

If the organisation was not able to prevent a loan from migrating into the NPL portfolio, the return can be maximised by following efficient processes with clear guidelines and a well-defined NPL strategy. As a first step, there should be objective criteria established to determine whether a loan will be moved into intensive care, restructuring, workout, or liquidation. An analytical scoring function can help to arrive at such a classification (see Figure 2). Within restructuring and workout, conflicting interests need to be accounted for, for example between maximising NPV for the bank, unattractive NPL bulks in the balance sheet, and risking reputational damage. To make sure that the actions the bank takes are consistent, clear guidelines need to be put in place to keep control and to enable timely adjustments to the steering impulses. For example:

- Goal: avoiding systematic delays → Lever: systematically contact clients immediately (ie, within the first two days) of payment delays
- Goal: optimising liquidation return → Lever: consider timing effects in liquidation of collateral
- Goal: satisfying external investors → Lever: run down NPL portfolio to improve overall quality of bank portfolio
- Goal: keep long-term reputation in marketplace high → Lever: avoid harsh treatment of debtors late in the collection phase.

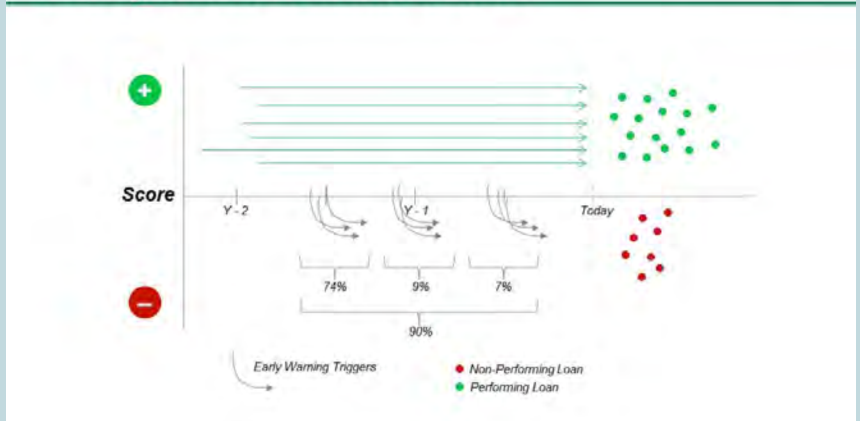

Figure 1: Early identification of potential defaults with early-warning scoring system

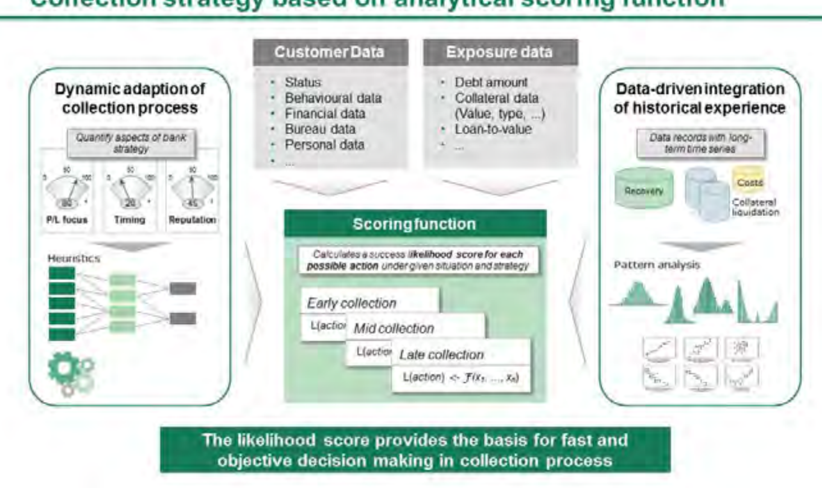

Figure 2: Elements of an analytical scoring function

CONCLUSION

Quantitative decision-making support can improve the value derived from NPL portfolios. In essence, starting with highly sensitive early-warning systems, continuing to selection criteria deciding on the most promising treatment of the debtor, then on to differentiated collection strategies and modelling of past experiences can provide valuable insights into how one can optimise non-performing portfolio management. However, such systems rely on collection of the right data – including behavioural data – and embedded processes which make sure the quantitatively derived conclusions get properly executed. The result of all these measures has been observed to increase the value derived from NPL portfolios by up to 20% and on occasion even manage a turnaround in the client's performance. This suggests that banks would benefit from investing further in their data modelling capabilities as part of their risk infrastructure maintenance.

DERIVATIVES RISK MANAGEMENT: THE IMPORTANCE OF UNDERSTANDING CORRELATION

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ABSTRACT

In this article we discuss the concept of correlation, and explain its relevance to finance. We start with a discussion of how it can be measured. We then move on to some simple products that allow us to trade the correlation and covariance. We explain the importance of understanding correlation impact on investment performance. Assets and other observable market instruments can be correlated for various reasons. We discuss some major causes of correlations below.

MACRO-ECONOMIC REASONS

If economic conditions change, this is likely to impact many assets in the same way, due to their exposure to systematic risk (referred to as Beta in the Capital Asset Pricing Model). The closer related that two assets are, the higher their correlation is likely to be. For example, almost all stock prices will have some kind of positive correlation. Changes in the values of shares of companies that are in the same country or business area will be particularly highly correlated. This is because there will exist specific risks that affect these closely related companies all to a large extent, while having less or no effect on the rest of the economy. For example, price moves of the shares of Mitsubishi and Nissan, both Japanese auto manufacturers, will be higher correlated than price moves of the shares of Nissan and Tesco.

CORRELATIONS AND VOLATILITIES IN A CRISIS

It is a well-known fact that both volatilities and correlations increase in times of financial stress. In normal market conditions, the value of an asset is determined by a combination of systematic (macro) factors that affect the market as a whole, and idiosyncratic factors that affect that asset in particular. Investors and other market participants seek to diversify their risk by taking out a wide range of investments.

In a crisis, the systemic factors start to dominate, compared to the idiosyncratic ones. For example, a default by a central bank will lead to correlated defaults by commercial banks in that country which hold a large proportion of their assets in the central bank's bonds. This, in turn, will lead to the default of domestic companies which have deposited their assets in the commercial banks. Policy-makers (eg, governments, central banks) intervene to a greater extent in the markets during a crisis. Under normal market conditions, there is a general desire to allow the economy to grow under its own steam, without taking any interventionist action. In a crisis, governments will intervene to try to avert the problems. These interventions can take many forms, including the printing of money, support for failing companies and banks, and changes in monetary and fiscal policy. These actions are more likely to have a systemic than an idiosyncratic effect.

It is also true that free market participants (eg, investors) behave in a more correlated fashion during a crisis. People become naturally more risk adverse, and will move their assets to perceived safe havens. They will prefer holding bonds to equities, government bonds to commercial bonds, and bonds of large robust economies rather than small volatile ones. As the crisis worsens, low-risk assets will appreciate compared to high-risk assets. As it alleviates, high-risk assets will appreciate compared to low-risk ones. Thus large groups of assets start behaving in an extremely correlated and volatile fashion.

CORRELATION AND CAUSATION

It is very easy to find things that are correlated but have no causal relationship. For example, the movements in the share prices of Mitsubishi and Nissan are highly correlated. However, this does not mean that a movement in the price of Mitsubishi shares will give rise to a movement in Nissan's. In fact, if all other economic (and other relevant) factors remained constant, but the Nissan share price fell (this could happen due any idiosyncratic reason, like a design flaw on a new model), you may actually expect the Mitsubishi share price to rise, as it captures market share from its competitor. The reason its share price movements are highly correlated is because the same set of external factors affect both companies in similar ways.

Correlation implies causation only if the correlation remains after the impact of all other factors has been accounted for. For example, if all economic, environmental and regulatory (etc) conditions remained constant over a six-month period, but the share prices still moved with a high correlation, then we would be pushed towards the conclusion that the movement in one price was causing the movement in the other (although we still would not know which was the cause and which the effect).

It is very hard to prove causation in economics, finance, and social science, because it is extremely hard, if not impossible, to perform a controlled experiment where other variables are held constant. It is much easier to prove causation in subjects like physics and medicine. Fortunately, from the point of view of a trader or risk manager, understanding the causation is less important than understanding the correlation (although if you understand the causation, this may help you search from highly correlated assets that can be used to hedge each other).

HOW CAN WE DEFINE CORRELATION?

Absolute levels or changes in levels?

A common mistake that people make is to look at the correlation between the absolute levels of two assets, instead of the correlation between the changes in these assets. In finance and economics, we normally think about price changes, rather than absolute price levels. So it makes sense to talk about the volatility of a price change, or the correlation between two price changes.

We can give a trivial example to show why considering the volatility of the asset levels is wrong. Consider a share whose values measured every month follow the pattern:

$$PV_{t+1} = PV_t * 1.01$$

This theoretical stock has no volatility at all. Its price is simply drifting upwards at a constant rate of 1% per month. If you measure the volatility of the price changes, you will get result zero. However, if you look at the standard deviation of the levels, you will get a non-zero level.

We can easily extend our example to correlation. Consider the two log-normal assets below:

Asset 1	Asset 2	Log change in:	
100	100	**Asset 1**	**Asset 2**
272	272	100%	100%
272	272	0%	0%
272	272	0%	0%
272	272	0%	0%
272	272	0%	0%
100	739	-100%	100%
100	739	0%	0%
100	739	0%	0%
100	739	0%	0%
100	739	0%	0%

In the first period, there was a large correlated change in both assets. In subsequent periods, there were no changes, apart from one perfectly anti-correlated log change. Both log changes are of the same magnitude. The correlation between the levels (measured using Pearson's formula) is -72%, but the correlation between the log-changes is zero! The zero level makes sense, if the only two changes that occurred were equal and opposite. Why is the correlation between the levels -72% then? This is because the second, anti-correlated change occurred when the absolute levels of the two assets were much larger, and thus had a much higher weight on the correlation of the levels than the initial change had.

While facile, this example serves well to demonstrate the dangers of looking at the wrong correlations.

MEASURING CORRELATION

As with all market parameters, we can estimate correlation in three ways:

- From the traded prices of instruments sensitive to the correlation
- From historical data
- Using economics and market knowledge to form an opinion on its value.

From the point of view of a trader, the first method, using tradable prices, is the best. This is the price at which the risk to the correlation can be hedged in the market. In the risk-neutral world, the trader should always mark his parameters to tradable prices. Unfortunately, there are not many liquid instruments that are traded inter-bank that are sensitive to correlation. Most correlation-sensitive instruments are not only traded with investors, but are quite often traded in the same direction. For instance, all the customer trades will result in the trader having the same directional exposure to the correlation parameter. Thus there is no price at which the bank can easily hedge its correlation exposure. Furthermore, these correlation-sensitive trades usually have exposure to other unhedgable parameters, and thus we have too many degrees of freedom to accurately determine the risk-neutral correlation from their prices.

Examples of potentially liquid instruments that have significant correlation exposure are quantos, spread options and correlation swaps.

In the absence of liquidly traded instruments, we have to rely on historical data and market knowledge. There are three major problems associated with using historical correlations to mark our models:

- The behaviour of assets can change over time, and thus future behaviour may not be the same as previous behaviour.
- There are sampling errors associated with the choice of a specific time-series. If we try to reduce the impact of sampling error by extending our sample further into the past, then we are assigning more weight to events further in the past that have less and less association with current conditions.
- Even if the past behaviour is expected to continue for the foreseeable future, this has not told us anything about the risk-neutral price where market participants may be prepared to trade the correlation. It has told us only about what we expect the real-world outcome to be.

When picking historical data, we have to ensure our fixing sources are as accurate as possible. A composite closing price of an illiquid instrument like credit default swaps (CDS) is likely to have a lot of measurement noise, as it is the average price reported by several market participants who all have wide bid-offers, and who may calculate their price at slightly different times of the day. However, the daily fixing of the USD ten-year swap rate, determined by ISDA, at a specific time, is likely to be very accurate and representative of a firm-tradable price at that moment. Any uncertainty adds noise to the calculation and will, on average, push the observed correlation closer to zero.

Another point to be aware of is to ensure the time-lag between the fixings of the two assets is as small as possible.

Imagine we are observing two assets, correlated at 60%. This correlation refers to the instantaneous changes in the two assets. Say that we observe each asset daily, but one at 1200hrs, and the other at 1600hrs. Consider a single observation period. Between 1200hrs and 1600hrs, we do not record any change in the second asset. Between 1600hrs and 1200hrs the next day, we record the changes on both assets. Between 1200hrs and 1600hrs, we record the changes only in the second asset. Hence, there is a four-hour window for each asset where there is no corresponding change in the other asset. Assuming there are no correlations between the moves in the two assets at two different times (which is a fair assumption, as otherwise markets would exhibit a predictive quality), this means that, out of the 24 hours, there was a four-hour period where no correlation is observed. The total correlation observed over many periods will thus be (60% * 20 + 0% * 4) / 24 = 50%. (We have made the assumption that there were also observations at the weekends, just to make the example simpler.)

This is illustrated at Figure 1.

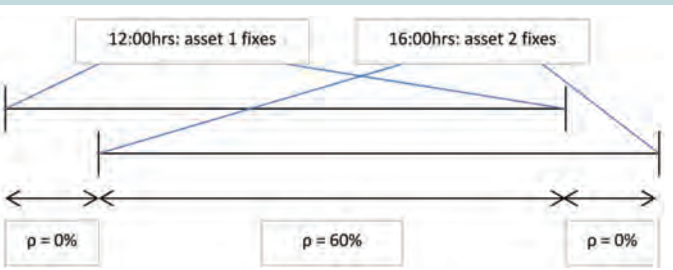

Figure 1 Time lag and asset-price fixing

We can get round this problem in two ways. If we know what the time lag is, we can use the above analysis to deduce the impact of the zero-correlation period, and thus adjust the final answer to the level implied for synchronous observations. This has the disadvantage of introducing more random noise into the data, especially if the time lag is large. Alternatively, we could increase the time between observations, to reduce the relative size of the lag compared to the observation gaps. This has the disadvantage of decreasing the number of observation points. For example, if we observe correlation weekly, compared with daily, we have five times less observations. This problem can be circumvented by using a rolling observation window, of say five business days.

Figure 2 shows the historical correlation between the changes in the S&P 500 index, and the EURUSD exchange rate. The correlations are measured using a 90-business-day rolling window of synchronous daily observations. The correlation has been high and positive since the 2008 credit crisis began, until the end of 2012. Before the credit crisis, there was no material correlation. In 2013, the correlation fell. This can be explained economically. Between 2008 and 2012, the euro had been seen as much riskier and more vulnerable than the US dollar. Thus, when the crisis deepened, EURUSD was likely to fall, whereas it was likely to rise as the crisis alleviated. Clearly the S&P index would fall at times of crisis and rise during times of recovery. At the end of 2012, the US had budgetary problems (including the 'fiscal cliff'). Europe began to recover from its economic woes. Thus, the euro stopped being seen as a lot more risky than the US dollar, and thus the correlation abated.

If we were looking at the historical behaviour of this correlation, with a view to using it to price a trade, we would have to think carefully whether we believed that the economic conditions that lead to the historical correlation levels would persist going forward.

This is a good example of the third bullet point made at the start of this section. If we do not understand the reasons behind an observed historical correlation, then assuming it is a good indicator for future behaviour is extremely dangerous.

CONCLUSION

Market valuations are influenced by a wide variety of factors and too often investors are familiar only with first-order factors. The reality is that the price of tradable instruments can and often does change as a result of changes in second-order factors, and the impact of correlation on value movement between two instruments is one such factor. We have discussed how this factor can change values and we can observe how changes in prices as a result of correlation impact make it important to understand what is the nature of any correlation and whether that is likely to influence future valuation.

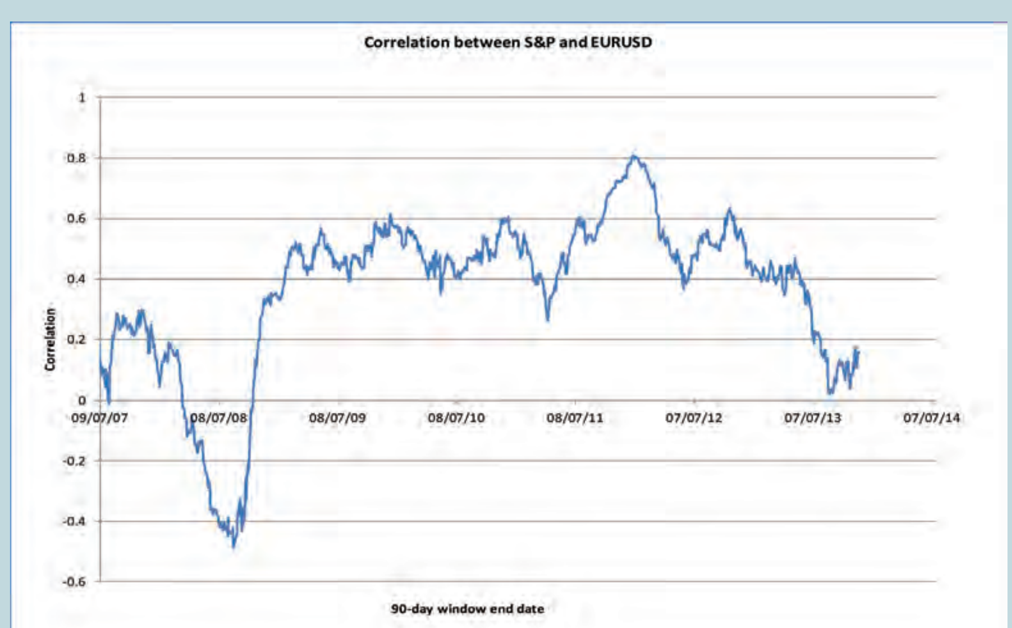

Figure 2 Correlation between S&P500 and EURUSD

SUBMISSION GUIDELINES

CISI members are invited to submit to the Institute for consideration papers on any aspect of wealth management, capital markets and banking. Articles must be:

- Original work and previously unpublished
- Between 1,500 and 3,500 words in length and accompanied by an Abstract of 80-150 words.

All papers submitted will be refereed by the journal editorial panel or its recommended reviewers. For further details about the Review of Financial Markets and how to submit articles, see cisi.org/academic

HAVE YOUR SAY

If you would you like to comment on any of the articles in this issue, contact CISI Communications Editor Richard Mitchell: email **richard.mitchell@cisi.org** or call **+44 20 7645 0749**

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SHABEER DANCING – FOURTH FROM LEFT

Shabeer's got talent

SHABEER BOOLY MCSI IS AS COMFORTABLE ENTERTAINING AS HE IS PROVIDING WEALTH MANAGEMENT ADVICE TO CLIENTS

LORA BENSON

Winning the favour of Simon Cowell, arguably TV's most difficult-to-please judge, is no mean feat. But Shabeer Booly achieved that distinction when he dazzled with his dance skills on *Britain's Got Talent*, the top-rated ITV programme.

Shabeer managed and starred in ThreeBee, a group that put a new spin on traditional Bollywood dancing. He says: "I wanted to promote diversity through dance, so I fused a classical Indian instrumental piece with 'Staying Alive', the classic disco track by the Bee Gees.

"Simon Cowell and his fellow judges Amanda Holden and Piers Morgan were extremely impressed and we got as far as the semi-finals, where the programme was watched by more than 10 million viewers. It was a life-changing moment for me."

That appearance in 2010 was a highlight of a wide-ranging career in entertainment for Shabeer that he fits alongside a busy job with Citi Private Bank in London's Canary Wharf.

Shabeer, who this year attained Chartered Wealth Manager status with the CISI, gives investment advice to clients in Africa, Greece and Israel. "Most of my annual leave from work, and the bulk of my weekends, are spent on my entertainment work, which enables me to combine the two jobs," he says.

SHABEER BOOLY, FIFTH FROM LEFT, ON STAGE AT BRITAIN'S GOT TALENT

"There are a lot of similarities between banking and entertainment as professions – they are both very competitive and demand a great deal of commitment."

Shabeer's prowess at Bollywood-based dance has been the source of much of his success, earning him appearances on programmes screened by all five terrestrial channels in the UK. His speciality is mixing Bollywood with different genres, including salsa – a personal favourite. He has performed on the TV lottery draw show, backed by pop group Duran Duran – and his dance skills helped secure him a role as a barman in the BBC TV series *Hotel Babylon*.

Shabeer was also cast as a trader in British comedy film Breaking the Bank

"In one scene, I was making a cocktail and it digressed into a daydream which involved full-on Bollywood dancing," he recalls.

His achievements also include being selected from more than 600 applicants for a dance scene in a TV ad for Heineken, which was shown across Europe.

But his screen appearances are not all dance related. He has, for instance, starred with his colleagues at Citi in a competition between workplace choirs. Shabeer was also cast as a trader for a cameo role in *Breaking the Bank*, a British comedy film to be released soon, which features *Frasier* star Kelsey Grammer and Mathew Horne from BBC TV's *Gavin & Stacey*.

Shabeer has added another string to his bow: presenting at major awards ceremonies and events. These have included the Pakistan Achievement Awards UK & Europe 2014 and the Miss Mauritius contest. He also presents a weekly show on a local radio station in his home county of Essex.

Shabeer's parents moved from Mauritius to England a few years before he was born, and he is in no doubt that his Mauritian roots are key to his passion for dance and music.

"Mauritius is one of the most diverse countries culturally, and from a very young age, I was exposed to music from all parts of the world, which inspired me and made me want to become an entertainer."

Shabeer's big break came when he passed an audition at 16 to join a dance group and began performing around the UK. He has performed in Dubai, Malaysia, Singapore, France, Hungary, the US and Turkey.

While he has a packed schedule, Shabeer is an advocate for the HeForShe campaign – a solidarity movement initiated by UN Women, a United Nations organisation for the achievement of gender equality.

He says: "This is a topic that is very close to my heart. Equality between men and women is something I would like future generations to experience."

Contact *lora.benson@cisi.org* if you have a hobby you think will interest other CISI members. You will receive a £25 shopping voucher as a 'thank you' if we publish your story.

Shock and awe

A NEW MANAGER IS DETERMINED TO IMPROVE THE PERFORMANCE OF HIS DEPARTMENT. SHOULD HIS WISH TO MAKE AN EXAMPLE OF ONE ERRING EMPLOYEE BE GRANTED BY THE DIVISIONAL HEAD?

Getty

Richard is the new head of an operations department, where a poor reputation has led senior management to focus increasingly on the area. He is renowned as being a demanding manager, some would say ruthless, and the department views his appointment with some trepidation.

On his first day, Richard calls the section heads into his office and tells them he is determined to improve the performance of the department, which means the elimination of the unacceptable number of errors that occur. He tells the section heads that they have a key role in driving the performance of their teams and thus his department, adding that he is aware of his reputation, which he admits is not undeserved.

After a week in his new role, Richard again summons the section heads into his office and draws their attention to the weekly errors report, which, far from showing an improving trend, shows more mistakes than ever before. He then reads out the text of a letter that he intends to send to all staff in the department, informing them that if all work is not checked, and the failure results in unacceptable errors, "it is highly likely that the individual… may face disciplinary action, which could result in dismissal." The new regime will be enforced immediately.

The impact of the letter is a sepulchral hush in the office and the working of longer hours by many of the staff, especially the section heads.

A week later, unprompted by Richard's ultimatum, the internal audit team carries out a snap audit of the department; this

identifies a number of errors, most of which are historic. However, Richard's attention is drawn to one specific item, which relates to an issue which is still current and includes entries made two days previously. This item concerns automated dividend payments into a client's account, where the original instruction has been wrongly set up, resulting in a series of duplicated payments being made to the client. Although none of the amounts is more than £25 and the total payments amount to about £200 being wrongly paid to the customer over a period, it is the apparent failure of his letter to make any difference which really upsets Richard.

Exasperated that this has occurred so recently, Richard asks who should have checked the entries and is told that it is Nadia, a longer-serving section head. Nadia has been in her position for a number of years, and has a mixed track record.

With a copy of his letter and the internal audit findings in his hand, Richard storms into the office of his Divisional Head. He demands that disciplinary action be taken to follow through on his warning, saying that he expects the Divisional Head's support, as this will be crucial in achieving the joint objective of an effective department.

The Divisional Head has a meeting scheduled imminently and so tells Richard that he will meet him later in the day. Before doing so, he runs through in his mind a number of key issues that need to be addressed before making a decision. Foremost is the need for any action that is contemplated to be fair and scrupulously to follow the firm's procedures but, bearing that in mind:

Richard demands disciplinary action be taken to follow through on his warning

- What sort of culture does the firm want?
- When is it appropriate for zero tolerance to mean zero tolerance?
- Does the operational failure meet this criterion?
- Do you want people to own up when they have erred?
- If so, how do you incentivise and encourage them to do so?
- Do you want to reward appropriate behaviour? How can you do so in this case?
- How might Richard feel if his Divisional Head does not support him?
- Should you weigh the materiality of Nadia's failure against the potential impact on the authority of your new manager?
- If he thinks disciplinary action is warranted, which might lead to dismissal, what would Nadia need to have done to avoid being dismissed? Where would he draw the line and what message does this send to other colleagues?

Having considered these questions, the Divisional Head determines that he has a number of potential courses of action, all of which have some merit, and wonders which one to choose.

Should he:

- Support Richard in his proposed course of action, to the maximum extent that it is permitted within the firm's employment policies, because he was selected to do a job and failure to support him at this stage will fatally undermine his authority?
- Support Richard in taking action, but ensure that it is proportionate to the actual incident, irrespective of the warning that he had sent out?
- Suggest that no action should be taken without involving HR in the decision, even if that results in losing the 'shock and awe' impact for which Richard clearly hopes.
- Suggest that no action should be contemplated that might have unintended consequences? Consideration must be given as to whether a hard line now will make matters worse or better.

What would you advise the Divisional Head to do?

Visit *cisi.org/shockandawe* 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&IR*.

PILE OF PROBLEMS: THE VERDICT

The 'Grey Matters' dilemma in the September 2014 print edition concerned a young man, Satish, who was asked by his boss, Eamonn, to sign off some management information as being correct, in order to ensure that it was submitted on time.

Such action would be in contravention of his firm's policies. Readers were asked what they would advise Satish to do, and were given four options to choose from. A relatively small number of people voted, but of the 64 who did, 73% agreed that perhaps Satish should tell the regulatory reporting unit why Eamonn's signature is missing and explain that Eamonn has 'authorised' him to sign the report. That is the option recommended by the CISI.

A significant point in relation to Satish not signing, despite Eamonn's apparent authority to do so, is that not only is it against the rules, but that he is taking on a personal accountability for which he is not authorised, and consequently he puts himself at unnecessary risk of sanction.

Just 6% of respondents voted that Satish should sign the report on the basis that it would keep his boss happy, although it would be in breach of company policy. Perhaps they assumed that no one would actually check the signature on the report, merely that it was submitted on time; a high-risk and inadvisable gamble.

Meanwhile, 20% argued that if he does not sign the report and waits for Eamonn to return, this may mean that the report is late, making the department look bad once again, which may affect his chances of a promotion. In reality, to take upon yourself the responsibility of signing something that you are not empowered to sign is likely to be far more damaging than not submitting a report on time.

No one felt that as Eamonn told Satish to sign the report, he can safely do so.

Catching the wave

THE CITY WOULD DO WELL TO LEARN FROM INSTITUTIONS THAT PLACE INTEGRITY AT THEIR HEART – LIKE THE ROYAL NAVY – THE CISI HAS HEARD THIS AUTUMN

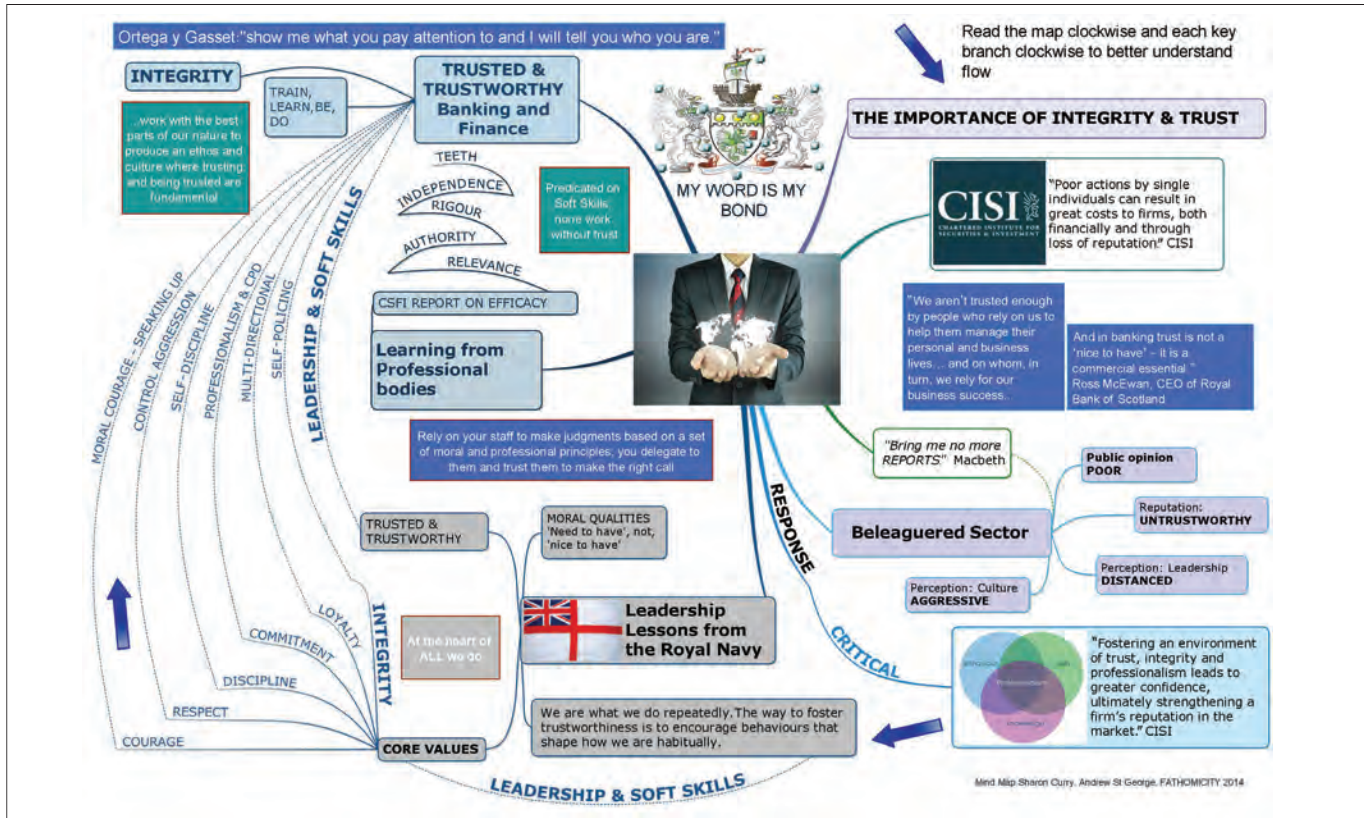
PROFESSOR ANDREW ST GEORGE AND SHARON CURRY

The UK banking and finance sector might feel the same as Shakespeare's Macbeth: Bring me no more reports. It is beleaguered by an army of journalists eager for the smallest breach of regulations, and besieged by an array of report-writers, each with a quiverful of recommendations.

Why so many reports?

What is it that the Chancellor, the Banking Commission, the Financial Conduct Authority and the Competition and Markets Authority, which have all been quite properly active in commissioning and delivering reports on the sector, really want? In a word, trust.

In November 2014, the Bank of England launched a wide-ranging review of London's markets in an effort to restore trust and to ensure that they are "fair, effective and trusted by all". Chancellor George Osborne said: "The integrity of the City matters to Britain. Markets here set the interest rate for people's mortgages,



How mind maps work – Great leaders have vision. They apply 'big picture/essential detail' thinking to everything they do. They step back often to see the picture as it changes and by doing so are able to associate diverse aspects of current practice, provide innovative solutions and get things done. 'Mapping things out' can make simple any complex task or process, enabling clarity and reducing error. Our brain loves images; they are our primary language, and they engage us emotionally and intellectually. Maps are images and provide an ideal 'big picture/essential detail' way of interacting with information.

the exchange rates for our exports and holidays, and the commodity prices for the goods we buy."

Sir Richard Lambert's Banking Standards Review 2014 stressed the importance of promoting high standards of behaviour and competence across the UK banking industry: "Success will help restore public trust in this vitally important sector of the economy." Over the next few years the CISI sees trust and integrity as two of the three pillars of professionalism, alongside helping students and members to attain and maintain their competences.

How might such a thing as trust be improved?

The City would do well to look at and learn from institutions that are both trusted and trustworthy, those that place integrity at the heart of all they do. Perhaps the longest-standing and most severely tested are the UK military. Here in the military, these moral qualities are not 'nice to have', they are 'need to have', and make a real operational difference in how things get done.

The core values of the Royal Navy readily translate into the financial sector

In the Royal Navy, for instance, the core values depend on moral courage, probity and integrity. They are: Courage, Commitment, Discipline, Respect, Integrity and Loyalty. All these readily translate into the financial sector, especially when you think of courage as moral courage (speaking up) and discipline as self-discipline. Trust of others and trustworthiness are of course central to those values; they are all interdependent; and they work in every part of an organisation. There is no room for dark recesses or rotten corners.

At almost any point in the day, we can make a decision that is either more or less courageous, or that bespeaks more or less trust or integrity. We are what we do repeatedly. The way to foster trustworthiness is to encourage behaviours that shape how we are habitually.

These behaviours are most acutely articulated in leadership – and in leadership throughout all levels of management – whose job it is to use refined judgment in uncertain situations to influence people to follow.

The military understands this intuitively. In the Royal Navy, leaders know that when things are volatile, uncertain, complex and ambiguous you cannot be everywhere to supervise your staff.

You have to rely on them to make judgments based on a set of moral and professional principles; you delegate this to them; you trust them to make the right call. And as a senior leader, you know that these judgment calls are being made minute-by-minute in difficult and fast-moving operations.

Two weeks before the battle of Trafalgar, the commander of the British fleet, Admiral Nelson, gathered his captains in his cabin on HMS *Victory*. He set out his intent clearly: the resources available, the strategy, the contingency and the moral inspiration for the endeavour they were about to undertake; every captain trusted him and was trusted by him. In fact, his famous signal right before the battle, "England expects…" was originally "England confides…" but there were not enough flags to make the signal! Confides, with its connection to both confidence and fiduciary duty, had a deep meaning for Nelson. For what can you depend on in uncertain times (like a sea battle)? You depend on your people.

Here on shore, things are less extreme. But under more benign conditions, as the Spanish thinker Ortega y Gasset said: "Show me what you pay attention to and I will tell you who you are." We need to pay attention to the right things, to spend time thinking about how to grow trustworthy people who can demonstrate integrity, loyalty and trustworthiness in all that they do. And then we need to grow them. This takes a profound effort.

What is to be done now?

The City can learn from its many professional bodies. According to a recent report from the Centre for the Study of Financial Innovation, there are several indicators of efficacy in a professional body. These are relevance (vital when professional bodies have no statutory role); authority (respected by employers and decision-makers); independence (making them a credible champion of the public interest); rigour (not just a box-ticking); and teeth (the ability to police a code of conduct and other conditions of membership). All these are predicated on soft skills; none will work unless they are trusted.

There is a crucial role for commercial players. Ross McEwan, CEO of Royal Bank of Scotland, put this bluntly in October 2014: "In February, I placed trust at the heart of my new strategy for our bank. The reason is obvious, but is also worth repeating. We aren't trusted enough by people who rely on us to help them manage their personal and business lives… and on whom, in turn, we rely for our business success. And in banking trust is not a 'nice to have' – it is a commercial essential."

There are also training, learning and thinking to be done. Soft skills and leadership that foster trust can be learned from good programmes as part of continuing professional development. The lessons of the military should be at the heart of this: these have been honed over centuries in the most extreme conditions, and work with the best parts of our nature to produce an ethos and culture where trusting and being trusted are fundamental.

And if trust is lost? Back to Macbeth, and the matter of broken trust. Right before Macbeth first appears in Shakespeare's play, the old king Duncan has just executed a faithless subject, and remarks: "He was a gentleman upon whom I placed an absolute trust." [Enter Macbeth]. That is a dramatic irony to which we should all pay attention.

Professor Andrew St George is an academic, business leadership consultant and author. He advises commercial, academic and public organisations. He wrote *The Royal Navy: Way of Leadership*, which is used as a leadership training manual for Navy staff. He is co-founder of Fathomicity, a consultancy focused on leadership, soft skills and collaborative mapping.

Sharon Curry is co-founder/owner of Fathomicity. She helps clients to visualise their organisational structure, processes and relationships by creating 'made to measure' programmes, presentations, seminars and workshops based on mind maps.

Further information
To find out more about the CISI's CPD courses and events, visit *cisi.org* or view this event at *cisi.org/cisitv*

Digital disruption

IT IS NO COINCIDENCE THAT THE UK'S LEADING FINTECH ENTREPRENEURS INCLUDE PLENTY WHO ARE NOT BRITISH BUT HAVE CHOSEN TO START THEIR COMPANIES HERE

ANDREW DAVIS JOHANNA WARD

If you asked a random sample of financial types to pick their buzzword for 2014, there's a good chance many would plump for fintech. The idea that there is a wave of digital disruption breaking over the stodgy world of traditional finance has gained much greater currency this year, however you choose to measure it.

Media coverage of the poster children of UK alternative finance – online peer-to-peer lending sites such as Funding Circle, RateSetter and Zopa, and equity crowdfunding operations like Crowdcube, Seedrs and Syndicate Room – is multiplying furiously. Apple's US launch of its payments-via-iPhone service attracted huge attention. Investors are now putting serious money into these businesses – from the $32m raised in June by Nutmeg, the online wealth manager, to the $5bn IPO price tag for Lending Club, the largest US peer-to-peer lending site.

Keen to ensure that the UK is able to maintain its position as one of the world capitals of fintech, the Government set up a review

Although the numbers are bigger in the US – as always – there is huge government interest in the UK's fintech scene, partly because of a desire to foster greater competition with traditional finance providers and partly because of a desire to avoid previous disappointments, when innovative British thinking in other fields has failed to translate into large, successful companies and the commercial spoils have ended up elsewhere.

The UK has undoubtedly produced a lot of pioneering fintech companies and enjoys some important advantages as a place to set up, notably London's position as the financial capital of Europe. It is no coincidence that the UK's leading fintech entrepreneurs include plenty who are not British, but have chosen to start their companies here – including Seedrs founder Jeff Lynn (US) and Taavet Hinrikus, an Estonian who was an early employee at Skype and then co-founded TransferWise, an online money transfer service tipped to achieve a $1bn valuation shortly.

Keen to ensure that the UK is able to maintain its position as one of the world capitals of fintech, the Government this autumn set up a review under the Chief Scientific Adviser, Professor Sir Mark Walport, bringing together a group of experts to examine how these financial technologies will evolve. It is expected to report early in 2015. Sir Mark's review follows close on the heels of Project Innovate, an interesting initiative from the Financial Conduct Authority that enables entrepreneurs pursuing disruptive ideas in financial services to engage with regulators much earlier than in the past, both so that they can receive timely guidance on the regulatory issues they will face and so that regulators can better understand how these markets are evolving.

Initiatives like these are important and should be applauded: unpopular though they may be, financial services represent a big and extremely important slice of the British economy and we stand to lose a lot if the UK falls behind the leaders in this field.

However, it is equally important to recognise that people involved in the fintech movement have a variety of agendas.

Fintech entrepreneurs naturally want the most favourable possible environment in which to create large new businesses that will make them personally wealthy. Policymakers also have an interest in seeing companies created in the UK that can achieve significant scale, but they have other interests too, notably ensuring that consumers receive better, cheaper and more effective products and services from all sources.

This is where it gets interesting and potentially controversial. The problem is that innovation in financial services cannot be patented or protected – as soon as someone comes up with an interesting new idea, there will be a host of imitators. As a result, size and incumbency count for a great deal in this industry, which makes it extremely hard for upstarts to break in and get big.

BIG PLAYERS

Sure enough, in recent months, signs have started to emerge that the big players are beginning to work out how to respond to the innovations coming from the fintech movement. Several banks are now engaging with P2P platforms or (in the case of RBS) apparently preparing to launch one.

Similarly, the online wealth management model pioneered by Nutmeg is attracting mainstream imitators: as a major participant in Nutmeg's June fundraising, Schroders is in pole position to acquire the business in due course, while both Hargreaves Lansdown and Barclays have indicated they are looking at launching something similar.

Those hoping to see a new generation of financial services companies emerge to challenge today's giants may end up disappointed. Although these innovations may change the market, it is quite possible that the real winners will be shareholders in mainstream operators that have the resources to reproduce the newcomers' business models and scale them more quickly.

That may be unwelcome news for fintech entrepreneurs, but it should not necessarily trouble the policymakers unduly, provided the benefits ultimately flow to the customer.

Traditional retail banking is dying as branches close. Firms and the public, fed up with the mainstream banks, are increasingly embracing alternatives to raise funds. So what is the future for the sector?

speak up

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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.

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