

THE  TIMES



HOW THE CITY REALLY WORKS

3rd edition

**The definitive guide to money
and investing in London's square mile**



Alexander Davidson

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Alexander Davidson



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*Cass academics provide comment and analysis on a wide range of issues from the global financial crisis, banking regulation and bank bonuses, to pensions and the latest management trends. Scott Moeller, Honorary Visiting Professor and Director of the Mergers and Acquisitions Research Centre at Cass, is an acknowledged commentator on M&A and author of *Surviving M&A: How to Make the Most of Your Company Being Acquired*. Here he offers his thoughts on the M&A market.*

In today's corporate world, working for a company merging or being acquired is almost certain to happen at some stage and it ranks among life's most stressful events. Everyone from senior managers to junior staff feels the tremors and most large mergers and acquisitions result in people being fired. The M&A process has a life of its own and not even the CEO of the company can control the changes taking place once the deal is announced.

The M&A market goes up and down. Each new merger wave – the last one peaked in 2007 – sets new records. This will likely happen again in a few years as the market recovers and especially with activity from China,

India and others. Even during recessions, it's a market which continues to power ahead, as witnessed by Kraft's recently agreed takeover of Cadbury. New entrants emerge who want to buy companies: in the 1980s, it was the leverage buyout funds, the 1990s saw more deals that crossed borders internationally and the rise of technology companies doing large deals with overpriced shares, and early in the new millennium it was the hedge funds, private equity firms, and venture capital companies that added volume to an already strong merger wave.

When the economy declines so does the cost of buying companies, this brings further buyers into the market. Sovereign wealth funds from the Middle East and Asia continue to have an appetite for purchasing large stakes in companies and targeting major industries. This is likely to continue - when one player steps off the stage another is ready to come on. The curtain hasn't closed on the M&A deal market.

Looking towards the future of M&A, two things will never change: first, a large number will fail to deliver what the architects of the deal promised, and second, whether the deal is successful or not, people will lose their jobs when companies combine. Many people get fired but many people survive as well. It's also an unfortunate fact that some of the survivors are not the best qualified or most experienced from the wide choice of internal candidates in the pre-merger companies. Politics and luck play roles in who survives, or maybe even an outsider is brought in.

You don't need to leave it all up to chance. There are some tricks of the trade from the hundreds of people interviewed for *Surviving M&A* – all of whom had lived through a takeover. Many, if not almost all, noted that if you want to improve the odds of being retained rather than fired common sense comes into play. Of course general good business practice is necessary, one should be perceived as someone who has a positive attitude about the company and about the specific merger or acquisition underway. Open criticism of the merger process and how management are handling the deal should be avoided.

But these survivors also explained that it is also crucial to be aware that one of the biggest myths during a merger: that those with merit will be recognised and retained. Employees and managers alike falsely assume that if they are better than their peers, this will be noted and they therefore are not at risk of being demoted or made redundant. Nothing could be further from the truth: leaving your corporate future to chance may be the

most dangerous decision. The secret of surviving a merger is instead to have a plan which seeks to protect your position and may even identify ways to exploit the situation and be promoted.

There are, of course, no guarantees that a job can be retained or found in a newly combined company, but an application of the tricks of the trade should improve the odds immensely. The best-run companies are often the most attractive acquisition or merger candidates because they are successful. When companies merge, job losses typically range from as few as one in ten up to one in every seven employees, but sometimes in rare cases even as high as one in three. Thomson Reuters reported that 24,000 employees would be made redundant after Bank of America had finished its acquisition of Merrill Lynch. What will happen at Cadbury? One certainty is that many will be looking shortly for new jobs.

The attrition rate is rarely spread evenly across the newly combined workforce. The higher up you are in the organisation, the more likely that your position has a comparable incumbent on the other side. The more senior you are in the firm, the higher the chance you will be made redundant in a merger. And co-CEOs or 'co' positions at any level rarely last long. At those levels, the survival rate is 50/50 at best, as maybe both may be replaced and a new senior executive team brought in.

Thus, the trip to the top of the business world is often determined by an individual's success in manoeuvring upwards through a number of mergers and acquisitions. Once near the top, senior executives may even design a merger in order to improve their own personal power where they believe their success is assured. Even if the deal isn't manipulated in any self-serving way by a CEO or board member, in modern business many do feel that the easiest way to progress upwards is through promotions achieved through mergers and acquisitions. Some may just be lucky, but others know how to play the acquisition game best.

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Reducing the risk factor

**By Charles Tilley, Chief Executive,
The Chartered Institute of Management Accountants (CIMA)**

The world economy may have been pulled back from the brink of collapse but it could be decades before trust in the system is fully restored. The big question now is how do we begin to rebuilt this trust? And more fundamentally, is it possible to prevent corporate greed and short-sightedness in the future?

One of the first steps on the path to improving confidence must be a renewed focus on corporate governance. It has been agreed by many financial experts that regardless of who is to blame, the crisis was unquestionably exacerbated by corporate governance failures. There is particular concern that many of today's risk management processes and systems of governance do not seem to provide a clear method of challenging high risk decision making.

No system is perfect: there will always be people who find a way around the rules. But measures must be put in place to keep excess and undue risk-taking to a minimum. A suggested roadmap has been laid out in the 39 recommendations by Sir David Walker in his recent review on British financial services.

One of the key recommendations in the review is a greater focus on risk. Sir David points out that the fast-changing environment of the global markets requires much more careful management of both known and unknown risk. To support this, he suggests that banks introduce risk committees in addition to the existing audit committees at board level. This, he says, should ensure that sufficient weight is given to emerging risks that are not captured in conventional risk management, control and monitoring processes.

In the international arena, the Organisation for Economic Co-operation and Development has also highlighted the importance of robust risk management from the top down. Moreover, it concludes that board-level engagement on the high-level risk process should be increased - with particular focus on the entity's risk appetite and tolerance. The Walker review further argues for stress testing to ensure that boards understand the circumstances under

which the entity would fail and be satisfied with the level of risk mitigation that is built in.

Looking ahead, the best solution may be to change behaviour rather than the law. In the aftershock of Meltdown Monday back in September 2008, stories began to appear in the business pages describing a culture of fear, cults of personality and mercurial leadership at the top of many of the financial institutions which crumbled. For a board to function effectively, Sir David Walker asserts that directors must have the confidence to challenge the status quo and the rationale of the executive.

The chairman of the UK Financial Services Authority, Lord Turner, has also emphasised the importance of banks receiving external challenges to assumptions of conventional wisdom. This is a step forward. But a challenge culture is not easy to define, create or maintain. There is a clear need for a description of what a 'challenge culture' within boards, and beyond, would look like and a map to show how it can be reached.

This underlines the need for behavioural change rather than more regulation. For a board to properly understand risk, integrate it into strategic thinking and demonstrating a rigorous and consistent approach, the emphasis should be on the quality of conversation about risk rather than simply ticking the boxes in a risk framework.

It is CIMA's view that to be effective in the long-term, organisations need to manage risk reliably throughout the business cycle. It is clear that risk management practices became too lax during the boom years. Nowhere was this more apparent than in the financial services sector where misaligned performance incentives and inadequate risk models led to excessive risk taking.

CIMA research has found that organisations tend to oscillate between under-scrutiny in good times and over-scrutiny in bad times. Sustainable performance requires reliable and consistent scrutiny over the long term. To quote Russell Palmer, former Dean of Wharton Business School, 'Greed reflects a failure of leadership; turning your head to ignore the risk because you are making big earnings today certainly shows a lack of leadership.'

To assist companies down the road to better risk management, CIMA has compiled a boardroom leadership model. This outlines the essential factors which combine to achieve board effectiveness. Previous reviews of governance have led to codification of the roles and responsibilities of boards and their committees. But recent events have demonstrated that, while useful, structures and processes have limited benefit. It is the behaviour of the leadership that is fundamentally important.

Having said this, it's also important to keep the structure under review. As a participant in one of our business breakfasts for FTSE350 directors pointed out, a good process can drive good behaviour. This may mean that processes should be reassessed: weak processes can lead to complacency while codification of best practice can set cultural change in motion.

So, while it may not be possible to legislate against greed, processes can be put in place to keep the culture of greed in check. Of course there are other factors to consider as well. It is my personal opinion that the banking sector's controversial bonus culture could be rationalised to encourage a focus on the long-term success of the company rather than the short-term gain of individual employees. Why not insist that a large slice of an individual's bonus is paid in equities and put into their pension? That way, they would have a direct stake in the long-term future of the organisation and would have no choice but to consider its sustainability.

Overall, I would concur with those who believe that bonuses have been too generous and need revision. The success of an individual employee is not the result of their personal skills alone: they have the reputation of the organisation and its wealth behind them. The rewards must therefore be proportionate to long-term input into the success of the company rather than short-term performance. In short, boards should only celebrate stellar performance once they understand the underlying reasons for it and, more importantly, the long term ramifications for the company and the wider community.

Foreword

Duncan McKenzie, International Financial Services London (IFSL)

The global financial crisis has impacted all financial centres around the world. London, as one of only two truly global centres as well as the hub for financial services in Europe, has been deeply affected by the crisis. Some firms and markets are undergoing major restructuring. In this new edition of *How the City Really Works*, Alexander Davidson brings us up to date on how the diverse markets that make up financial services in London fit together, and how they have fared.

Prospects for some firms and markets in London that were deeply affected by the crisis have been improving. Banks are recapitalising and hedge funds have generated improved returns in 2009 following negative returns and outflows during 2008. Securitisation markets, however, are still largely limited to repurchase schemes operated by central banks, so the primary market for securitisation in Europe remains largely closed. Other sectors, such as insurance, fund management and securities markets, have been less affected by the crisis but have experienced a slowdown or fall in business that might be expected during an economic downturn.

International coordinated action by governments and central banks has staved off the prospect of a 1930s-style recession and helped to rebuild confidence in the global financial system. Downside risks are diminishing but much work remains to be done. IFSL's key priorities for reform of financial regulation at national, EU and global levels include more convergence of the world's regulatory and supervisory regimes; development of market structures that promote competition and openness to international participants; and regulation that blends necessary controls with scope for innovation.

Despite the setbacks and the broad challenges facing the financial sector, London's continuing prospects as the premier financial centre of Europe are underpinned by a number of factors:

- The structural strengths – diversity of markets, strong skills base, global orientation and legal system – that underpin London’s status as one of only two global financial centres remain in place.
- Beyond specific challenges in banking, securitisation and hedge funds, financial markets in London have continued to function efficiently and without interruption despite volatility and loss of confidence.
- London once again came top of the rankings in the September 2009 edition of Global Financial Centres Index commissioned every six months by the City of London Corporation.
- Global regulatory reform offers a framework for embedding the lessons of the crisis.

London’s position as the premier global financial centre is founded on the transaction of more international business than any other centre worldwide: for example 19 per cent of cross-border bank lending out of London; 36 per cent of foreign exchange trading; and 43 per cent of over-the-counter (OTC) derivatives. In other areas, such as hedge fund assets and private equity investment, the large US domestic market puts New York ahead of London but London – with 18 per cent of global hedge fund assets and 17 per cent of private equity invested – is the leading financial centre by far in Europe.

Professional and other supporting services also play a crucial role in supporting the financial services cluster. International law firms, in particular, have created large international networks which have put three London-based law firms on top globally, facilitated by the widespread use of English law. A friendly legal framework for arbitration and alternative dispute resolution has also contributed to London’s status as a major centre for international dispute resolution.

While some of the markets that contribute to the London cluster have long historical origins such as commercial banking, insurance, fund management and maritime services, the cluster has expanded as London has been able to take a lead in many of the new markets that have developed over the past half century. The international bond market put down roots in London in the 1960s, followed by the modern financial derivatives market in the 1970s and hedge funds in the 1990s.

In recent years, London has also taken the lead in developing a fully functioning carbon market, aided by the UK piloting its own emissions trading scheme ahead of the EU. The UK has also stolen a march on other Western countries in developing a nascent market in Islamic finance. The UK has adapted its legal framework so that, from a tax and regulatory perspective, Islamic sharia compliant financial services are treated on the same basis as conventional

financial services. London now has far more banks supplying Islamic finance than the rest of western Europe combined.

Implicit to this is the fact that financial services are, above all, about supplying relevant products which meet the requirements of individuals, businesses and other organisations. None of this is to underestimate the domestic and international challenges that lie ahead; these are substantial but can be addressed and resolved. And a key factor in facing up to such challenges is information and understanding how people can become better informed as to the nuances of complicated financial marketplaces such as London, Tokyo and New York. This third edition of *How the City Really Works*, published in association with *The Times*, is an excellent starting point for anyone looking to learn more about the City and the Square Mile, and London's role in international finance. Alexander Davidson has, once again, done an incredible job of distilling a wealth of information into a single publication, and he is to be commended for having done it in a clear, succinct and understandable manner.

Duncan McKenzie
Director of Economics
International Financial Services London

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Acknowledgements

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With this proviso, for the third edition, I received help, in no particular order, from many City institutions, including, but not confined to, the Association of British Insurers, the Association of Chartered Certified Accountants, the Bank of England, the Baltic Exchange, the London Stock Exchange, PLUS Markets, Euroclear, SWIFT, LCH.Clearnet, NYSE Liffe, the Building Societies Association, the London Metal Exchange, FTSE International Limited, Compeer, the Association of Investment Companies, the National Association of Pension Funds and Lloyd's.

Denis Peters, corporate communications director at Euroclear, gave this new edition a full reading. His substantial knowledge of the City and his eye for detail added, as ever, significant value to the text.

I have drawn extensively on research produced by International Financial Services London, which is useful for anybody with an interest in the City. On regulatory issues, I am indebted to the output of the Financial Services Authority in particular. There are City people with whom I talk regularly in my work as a journalist whose insights are reflected in the book, and I would like to thank these professionals. I owe much to organisations such as the Chartered Institute for Securities and Investment and the Chartered Insurance Institute, and to many trade bodies and financial institutions, as well as to the research of academic institutions, particularly Cass Business School.

In the previous editions of this book, I have had significant help from many other institutions including, but not confined to, the Council of Mortgage Lenders, the Asset Based Finance Association (formerly the Factors and Discounters

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Charles Newsome, investment manager at Christows, commented helpfully on earlier editions. Jim Rogers has helped on commodities. Jill Leyland, economic adviser to the World Gold Council, has explained gold markets and Peter Sceats, expert witness and consultant director of business development at TFS London, gave some perspectives.

Anna Bowes at Chase de Vere Financial Solutions, Justin Modray, Kevin Carr of Lifesearch and Tom McPhail, Head of Pensions Research at Hargreaves Lansdown, have helped earlier research on personal finance. The Financial Ombudsman Service has provided insight into its services.

The International Capital Market Association has commented on earlier bonds coverage. Chris Furness, senior currency strategist at 4CAST, gave me insight into foreign exchange. The British Insurance Brokers' Association has always been helpful.

Important note

This book aims to explain the City understandably, using simple language and generic examples. The wording does not have the status of legal definitions, and this guide is for educational purposes. It should not be used as a definitive source, or in particular as a substitute for investment advice. The book is necessarily selective and seeks to cover only the main City activities. It may reflect some of the author's preferences. The City changes quickly and the details in this book may become out of date, but the overview will stay true.

Abbreviations

When I use the name of an organisation for the first time in a chapter, I spell it out in full. Subsequently I abbreviate it. For example, you will find the Financial Services Authority referred to subsequently as the FSA, and the London Stock Exchange as the LSE.

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HOW THE CITY REALLY WORKS

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3 ■



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The City of London

Introduction

In this chapter we shall define the City of London in geographical and product terms, and see how it has developed from the cosy club that it was until the mid-1980s to the competitive international marketplace it is today.

The City defined

To define the City, we need to consider its range of activities. The City encompasses wholesale financial services, which are money and/or financial instrument exchanges between professionals, or between professionals and companies or governments, as well as some retail activity.

Geographical positioning is another defining factor. The City operates in or around the geographical square mile in the centre of London. There are nuances. A stockbroker dealing with retail clients is considered part of the City, provided that the firm or its head office operates within or near the square mile.

As a variation, somebody who works at a City head office of a clearing bank can claim to work in the City, but a colleague working for a provincial branch cannot. If a firm only sells insurance, pensions and unit trusts, this is not in itself City activity, even if it operates within the square mile. But stockbrokers that also offer these general financial services are considered part of the City. Commercial insurance professionals who work in the London market are also part of the City.

The firm's head office is usually where senior management is located, and this is fundamental even in an era where electronic links cross geographical boundaries with ease. The City still relies on face-to-face contact.

Over the years, the physical boundaries have extended beyond the traditional square mile. One of the most important City locations is Canary Wharf,

part of the Docklands, where some leading banks, including Morgan Stanley and Credit Suisse, are based, as well as the Financial Services Authority (FSA), which regulates all financial services in the United Kingdom.

Sometimes the London operation has foreign ownership, which has contributed to London's success as a financial centre. The London International Financial Futures Exchange (LIFFE) is owned by NYSE Euronext and forms the hub of the group's international derivatives business, NYSE Liffe. This foreign ownership has given LIFFE access to capital to build its business and obtain access to foreign markets. As another example, London-based ICE Futures Europe is a wholly owned subsidiary of Atlanta-based Intercontinental Exchange.

Financial markets

Financial markets give borrowers an opportunity to raise capital, making contact with lenders through banks and other intermediaries. Commercial banks take deposits and lend them to borrowers. Investment banking involves selling the securities of corporate or government issuers to investors. Securities may be debt instruments, such as syndicated loans or bonds, or shares. Following issuance, securities may be traded on relevant exchanges and trading platforms, or in the over-the-counter markets.

From the investor's perspective, cash deposits and bonds are at the low end of the risk spectrum, and equities and derivatives are at the high end. Institutional investors allocate assets in their portfolios across these types of investments to spread the risk. For example, they may hedge their bond and equity positions with derivatives. If they lose a substantial sum on their main securities portfolio, they will gain on the derivatives, and vice versa.

Traders may speculate on derivatives, as well as on equities or other financial instruments. They have a more short-term approach than most retail and institutional investors, which means that they pay close attention to rumours about mergers and acquisitions, pending earnings announcements and daily news flows than to company fundamentals.

The City as a world leader

London, along with New York, is one of the true leading global financial centres, according to International Financial Services London (IFSL). The IFSL research consistently shows that New York sources much of its business from its domestic market, although New York surpasses London in foreign equities turnover, and

private equity and hedge fund assets. In comparison, London has the largest share of many international listings.

In cross-border bank lending, at the end of 2008, the United Kingdom had an 18 per cent global market share, down from 21 per cent a year earlier, and the United States had 8 per cent, according to *International Financial Markets in the UK* (IFSL, 2009b). In foreign exchange turnover (October 2008), the United Kingdom had a 35 per cent share of the market, down from 34 per cent, against the 16 per cent market share of the United States, its nearest rival. The United Kingdom had a 22 per cent turnover in foreign equities, down from 46 per cent, compared with 67 per cent in the United States. The United Kingdom is the market leader in international bonds (2006), with 70 per cent of the secondary market.

In over-the-counter (OTC) derivatives, the United Kingdom had a 43 per cent market share (April 2007), according to IFSL statistics. The United States has 24 per cent. In marine insurance net premium income, the United Kingdom has a 20 per cent market share (2007), while the United States has 10 per cent. London's share of world hedge fund assets was 18 per cent at the end of 2008, which was slightly down on 2007 when it was 20 per cent. The United Kingdom has a long way to catch up with the United States at 69 per cent.

The United Kingdom had 7 per cent of private equity by investment value in 2007, down from 14 per cent in 2006, compared with the 71 per cent share of the United States. The United Kingdom had 14 per cent of securitisation issuance in 2008, up from 6 per cent the previous year, and compared with 55 per cent in the United States.

In 2008, the United Kingdom had 8 per cent of initial public offerings (IPOs), down from 18 per cent in 2007, compared with 4 per cent for the United States.

No gain without pain

London has concentrated expertise, is well placed in the time zones between New York and Japan, and its regulatory regime sets international standards. To reach this position, the City has historically taken risks. The United States has invented such products as exchange-traded funds, financial derivatives and credit derivatives, and the City of London has adopted and exploited them.

The City has reached its current status through trial and error over the decades. In the 19th century, the UK merchant banks, later to be known more widely by the US term *investment banks*, developed rapidly, but with the advent of the First World War in 1914, some failed to retrieve monies owed to them and almost collapsed. They survived only because the Bank of England gave them special loans. Following the war, the banks became independently successful

again. After the Second World War broke out in 1939, investment banks suffered financially once again.

International securities were the break that restored the City's fortunes. The Eurobond market started in London in July 1963 and received a competitive boost thereafter when the United States introduced a compulsory US interest equalisation tax, which drove issuers away.

The fortunes of sterling have been a more broadly based factor in building up the City. In the late 1970s, sterling rose sharply because of the North Sea oil bonanza, and in October 1979 the Conservative government under Margaret Thatcher as prime minister abolished the exchange controls limiting the amount of currency that UK residents could exchange for another national currency. This removed a restriction on the rise of sterling that had been in force since 1939. UK institutional investors started adding substantially to their overseas investments, although mostly through foreign brokers.

In the 1980s, the London Stock Exchange (LSE) was the unrivalled leader among European exchanges. In July 1983, it came to a historic agreement with the government to abolish fixed commission rates and the single capacity role for stockbrokers as agents for clients, a move intended to make brokers more competitive. The changes came into force on 27 October 1986, and were known as *Big Bang*.

The jobber had been a wholesaler of stock to the broker, but was suddenly made obsolete. In came broker dealers, whose role merged the previous responsibilities of the jobber and broker, and market makers. Overseas securities firms could for the first time become members of the LSE, and trading on the floor of the Exchange was replaced by the screen-based Stock Exchange Automated Quotations (SEAQ) system.

At around the time of Big Bang, US banks were coming to London because the Glass–Steagall Act prevented them from conducting retail and investment banking business simultaneously. The popular perception of the City had been as a club of florid-faced ex-public school chaps with a penchant for long liquid lunches. With Big Bang, a new type of City worker, competitive and egalitarian, was stepping into key roles.

Information technology, including the electronic order book on the LSE, has helped to make trading more prolific. In the London insurance market, the development of electronic processing of paperwork has helped to address, among other issues, past failures to provide timely contracts.

To cope with these and other demands, including regulation, a growing product range and increasing internationalisation of the culture, financial services staff have learned to be flexible and, often, to develop a specialisation. The equity salesperson or analyst may have little knowledge of the

bond market, while for bond salespeople, their ignorance is about equities. Neither of these specialists may know much about the commodities markets or Lloyd's insurance.

At the same time, the various parts of the City are interlinked and an event in one market can create a chain reaction in another. Bond issuance is supported by the swaps market, which enables some borrowers to swap their obligation for another that is more congenial. Derivatives hedging cannot exist without liquidity provided by speculators. Deposit accounts and various financial instruments are affected by foreign exchange movements, which are impacted by interest rate movements, in turn driven by inflationary pressures.

The macroeconomic numbers are under scrutiny by a vast army of City strategists and economists paid ample money to sit glued to their screens and bark out their opinions and forecasts. Securities analysts harness this and other data to prepare research that may assist, in particular, the lucrative investment banking divisions within the same firm, although regulatory developments have meant that the conflicts of interest between analyst research recommendations and investment banking relationships must be properly handled. How strategists and analysts communicate with the City is strictly regulated, but there are informal as well as formal channels.

The sophisticated way in which the FSA regulates the City helps its image abroad, although such problems as Northern Rock have had a smearing effect. Many banks in the City are foreign owned, and the LSE has attracted a large number of listings from non-UK firms. Managers of hedge funds, a relatively unrestricted form of investment vehicle, favour London as a European location, but this may become less so because tax efficiency is stronger in, for example, Ireland and Switzerland. Now, tax havens are facing regulation under an EU directive, and unless the wording is substantially changed from that proposed, hedge funds managed in these locations will particularly bear the brunt. The Lloyd's insurance market has kept a high international reputation in rocky times, and following the US government bailout of American International Group, is attracting renewed interest in the United States.

At the same time, some City institutions have seen their roles diminished in some respects. The Bank of England no longer supervises the banking system, and its main focus is on monetary policy. Events during the financial crisis suggest that this limitation may have been ill conceived. The Bank of England in its old (pre-1997) role as bank supervisor would perhaps not have allowed Northern Rock to open for business with its problems unresolved, a state of affairs that led to the run on the bank. Across the City, consolidation is frequent, as firms seek economies of scale and synergies to survive. In mid-2007, the LSE agreed a merger with Borsa Italiana, the Italian stock exchange.

In financial services regulation, the United Kingdom and the United States, for example, make uneasy bedfellows, although the large US banks, for one, manage to straddle the two jurisdictions effectively. The UK outcomes-based regulatory regime puts the onus on firms to make their own interpretations, while the US regime is rules-based. The US Generally Accepted Accounting Standards differ from International Financial Reporting Standards both in framework and in some crucial areas, including fair value accounting, and the move towards convergence, although it is happening, is slower than many had hoped.

The United Kingdom remains under pressure to conform to pan-European regulatory standards, as established in the directives imposed on European Union states by the Financial Services Action Plan.

Markets are people

The City still has a reputation for being a world apart, and its workers do tend to enjoy better opportunities than may be available, for example, to metal workers in the north of England. Many are doing mundane work for above-average pay, and it is mainly those who work in frontline jobs who have opportunities to make a spectacular income.

As the City has developed in size and international stature, it has demanded increasingly better-educated entry-level workers. In these days of programmed electronic trading, the demanding jobs are likely to be filled by mathematicians, economists and computer whizzes, many from France, Germany or Russia.

For bright university graduates, the City is often their first career choice. A good numerate degree, better still followed by an MBA, in either case from well-regarded institutions, can open doors, but personalities must also be right. It is no secret that the front-line jobs in the City require heavy socialising and sales skills, and an ability to deal with clients, a criterion fully reflected in today's stringent recruitment process.

In the City, status comes from the size of the pay packet and bonus more than the intellectual demands of the job, although some fund managers prefer to see it differently. The City has its professional exams, and the programmes have become increasingly flexible.

Career openings are varied. The City has a small army of support staff ranging from IT professionals to settlement clerks, editors, newsletter writers, press officers, trainers and others. Some are more highly qualified than others, and for back-office processing, there are plenty of temps. Support services are increasingly being outsourced to cheaper locations such as India, which carries its own risks.

At the end of 2008, 324,000 people were employed in City-type jobs in London, down 29,000 on the previous year, according to data compiled by IFSL. Generally, jobs are not safe in the City. The large financial institutions are constantly reconstructing themselves, and may downsize their operations based on their own circumstances as well as market conditions.

The future

As the third edition of this book goes to press, London has been hit hard by the credit crisis and recession. Some banks have been nationalised or recapitalised, and hedge fund assets have depleted.

The financial crisis of 2007–10 has blown open some of the flaws. Regulation of banks' capital adequacy was flawed. There has not been enough transparency around credit derivatives. Credit rating agencies have been found by regulators to operate with dangerous conflicts of interest. The bonus structures in banks have encouraged unbridled risk taking to generate short-term profits.

London nonetheless remains attractive, not least because of a time zone overlapping with Asia in the morning and the United States in the afternoon. The City is open to foreigners, and it has a growing Islamic centre. English is the international language of business. London has a diverse financial infrastructure and an acclaimed regulatory regime.

The next step

Understanding the City requires you to grasp not just something about its individual activities, but also how they fit together. This book aims to give you the whole picture. In the next chapter, we will examine the role of the Bank of England.



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The Bank of England

Introduction

This chapter is about the Bank of England. We shall focus on its history and its activities, including open market operations and the Monetary Policy Committee. We shall look at how the Bank took extraordinary measures in the credit crisis, including quantitative easing. The impact on the Bank's activities of the Banking Act 2009 is also explained.

Origin

The Bank of England is the United Kingdom's central bank, established in 1694 as a private company to help the British government raise cash to finance a war against Louis XIV of France. The Bank is the Government's banker, and since the 18th century it has also been a bank for UK banks. By the Bank Charter Act 1844, the Bank of England gained the exclusive right to issue banknotes in England and Wales. In 1946, the Bank was nationalised.

Until 1997, the Bank was the supervisor of banks and, from a separate department, government adviser on monetary policy. The banking crisis of 1973–75 revealed weaknesses in the Bank's informal supervisory approach. There were legislative developments with the passing of the Banking Acts of 1979 and 1987, but the Bank's continued role as a banking supervisor came under increasing scrutiny, particularly after the July 1991 collapse of Bank of Credit and Commerce International (BCCI). In October 1992, Lord Justice Bingham found in his report on the events that the Bank had not pursued the truth 'with the rigour which BCCI's market reputation justified'.

Deloitte, the liquidators of BCCI, brought an £850 million lawsuit against the Bank of England, claiming 'misfeasance in public office'. In November

2005 the case collapsed and the Bank was thoroughly cleared of any allegations of dishonesty in relation to its supervisory role of BCCI.

The Bank's role of banking supervision came under new scrutiny when Barings collapsed in 1995 after its trader Nick Leeson had lost over £800 million through unauthorised trades in derivatives. Barings, as a major investment and trading bank, had been obliged to seek authorisation from the Bank of England for its banking business, from the Securities and Futures Authority for securities dealing, and from the Investment Management Regulatory Organisation for investment management. The mix of regulators required for so diverse a bank had made supervision difficult.

Changes to the supervisory arrangements had become inevitable. The Bank of England Act 1998 transferred the role of authorising and supervising banks from the Bank of England to the Financial Services Authority (FSA), the then new single financial services regulator.

Role

The Bank of England exists to ensure monetary stability and to contribute to financial stability. It also manages the United Kingdom's gold and currency reserves on behalf of HM Treasury. The Bank can intervene in the money markets and, in accordance with government policy, can intervene in the foreign exchange market. The Bank can also intervene in foreign exchange for the purposes of monetary policy.

As part of its role, the Bank oversees payment and settlement services under the Settlement Finality Directive adopted in May 1998, a process which has now become more formalised. All the clearing banks keep accounts at the Bank, using them to settle differences between themselves through the cash clearing system provided. They exchange cheques written by each other's customers, and move credit.

Globally, the Bank of England liaises with such organisations as the International Monetary Fund and the Bank for International Settlements, and it is a member of the Financial Stability Board.

The 1998 Bank of England Act has set the framework for governance and accountability, which the 2009 Banking Act has modified. The Court of Directors manages the affairs of the Bank other than formulating monetary policy, and it now also has a statutory objective to 'contribute to protecting and enhancing the stability of the financial system of the United Kingdom'. The Court consists of the Governor, two deputy governors and nine non-executive directors. Under the 1998 Act, a committee of court, consisting of all the non-executive directors,

is responsible for reviewing the bank's performance and the procedures of the Monetary Policy Committee (MPC), which makes interest rate decisions.

Inflation targeting and the MPC

Traditionally, the Bank of England advised on interest rate policy, and it was the Chancellor of the Exchequer who decided on interest rates. When Labour won the May 1997 general election, Gordon Brown, then the new Chancellor, gave the Bank of England full responsibility for monetary policy, which meant operational independence to set the interest rate.

It was a surprise move, and Labour's response to concerns that the government should not set interest rates because of conflicts of interest with its political agenda. On Chancellor Brown's request, the Bank established an MPC to make interest rate decisions. The MPC consists of the Governor of the Bank of England, appointed for a five-year term by the chancellor, and two deputy governors, also appointed for five years, as well as the Bank's chief economist, its executive director of market operations, and four external members, mainly economists.

The way the system has worked since May 1997 is as follows. The Chancellor defines price stability and sets the annual inflation target, measured by the Consumer Price Index (CPI). The Bank has the task of keeping inflation at the target and maintaining monetary stability, and it is to support the government's economic policies, including its objectives for growth and employment. Currently the CPI target is 2 per cent.

To keep inflation within target, the MPC has the power to change the bank rate, which is defined as the official rate paid on commercial bank reserves held at the Bank of England.

In a monthly two-day meeting, held on a Wednesday and Thursday, the MPC determines whether to change the interest rate. The committee considers economic indicators and surveys, including the consumer prices index (CPI), earnings growth, the Purchasing Managers' Index, producer prices, gross domestic product, retail sales, house prices, exchange rates and the outlook for the world economy.

In making its decisions, the MPC considers its inflation forecast two years ahead and sets policy accordingly, as it can take up to two years for the impact of bank rate changes to feed through across the economy. If the economy is growing fast and employment is rising, the Bank may raise the rate to curb inflationary pressures, but if the economy is starting to slow, it may choose not to change the bank rate. On the second day of its meeting, the MPC takes a majority vote on interest rates, announcing its decision at noon on the Thursday.

If the MPC should change the bank rate, retail banks often quickly change their own lending rates. They often, but not invariably, set them at a margin above the base rate. If rates are raised, this slows consumer spending and makes it more expensive for companies to borrow, which can slow their growth; depositors can get a higher return on their bank deposits, and so may switch investments from shares into cash, which reduces the value of the stock market.

The minutes of an MPC meeting are published 13 days later, and strategists pore over the minutes, looking for clues about possible changes in interest rate policy ahead.

The Bank also publishes a quarterly *Inflation Report*, which takes a retrospective look at recent progress and makes inflation and GDP growth forecasts.

Inflation

Inflation may be defined as a continued rise in price levels that diminishes the value of money. Experts cannot agree on the cause. Some cite cost-push inflation, based on rising manufacturing costs, and others believe in demand-pull inflation, based on demand exceeding supply. Monetarists attribute inflation to a money supply that has grown too quickly, a view now out of favour.

Business has an incentive to increase the profit margin and so create inflation, but competition makes it difficult. Markets are more efficient than in the 1960s and 1970s, when employees routinely bargained through their unions for high wages. Inflation is a necessary part of economic development but when it becomes high, prices become detached from value and central banks fear that, without proper controls in place, the economy could become unmanageable.

Checks in place

Inflation targeting, as practised by the Bank of England, has had a clear impact in nurturing UK inflation expectations. Should the MPC prove unable to maintain the 2 per cent annual inflation target, there are numerous accountability checks in place. If inflation is more than 1 per cent above or below target, the Governor of the Bank must write an open letter to the Chancellor to explain the reasons why inflation is not on target and the measures that the Bank will take to bring inflation back to target. The Governor wrote the third of these letters in September 2008, after inflation had peaked at 5.2 per cent that month. This has been followed by letters in December 2008 and again in March 2009.

When Lehman Brothers collapsed in September 2008 and financial markets panicked, the MPC cut the bank rate from 5 to 0.5 per cent in only five months, which was unprecedented. In March 2009, the MPC voted to use the new Asset Purchase Facility (see below).

Under extreme circumstances, the government can also direct the Bank on monetary policy for a limited period under provisions contained in the Bank of England Act 1998.

Money market operations

The Bank can influence the money supply not just by its interest rate decisions, but also through its open market operations (OMO), where it lends money to banks in the money markets to provide liquidity. The Bank uses its OMOs to buy securities from banks daily, both outright and through repos, which means buying securities and later selling them back at a higher price.

During the recent financial crisis, the Bank acted to provide amounts of liquidity to the UK financial market. The Bank extended its open market operations and also introduced the Special Liquidity Scheme, which enabled bank and building societies to swap some of their illiquid assets for treasury bills issued by the Debt Management Office.

The Bank also introduced reforms to its money market operations, including a permanent Discount Window Facility. We shall look at these developments in more detail later in the chapter.

Keeping control

So far, the UK government's refusal to join the euro has kept the Bank of England in control of UK interest rates. If a future UK government should wish to join the EU single currency area, it might offer a nationwide referendum on the matter. Should the UK decide to join the euro, the European Central Bank's (ECB's) decision on monetary policy would prevail.

Lender of last resort

If a bank encounters liquidity problems and this could have adverse impacts across the financial system, the Bank of England can act as a lender of last resort. The criteria for intervention are intended to be stringent. In 1995, the Bank of England decided not to intervene to save Barings from going bust partly because it considered that such a failure would pose no systemic threat to the UK banking system.

In other cases, the Bank of England has intervened. For example, in 1984, the Bank helped Johnson Matthey Bankers Ltd, a London market maker in gold

bullion, which had experienced financial difficulties from its commercial lending. If the operation had been allowed to fail, there might have been a crisis of confidence in the London gold market.

In September 2007, the Bank of England agreed to provide Northern Rock, a mortgage lending bank, with ‘as much funding as may be necessary’, after it faced liquidity issues, which also threatened its solvency. Northern Rock obtained three-quarters of its funds from wholesale markets, which had dried up because of the US sub-prime mortgage failures (see Chapter 12).

Some queried whether the crisis at Northern Rock had justified Bank of England intervention, which on the Bank’s own criteria should have occurred only in the case of systemic threat. Northern Rock had been only the fifth largest mortgage lender in the United Kingdom. The critics said that the move helped to create moral hazard – encouraging banks to lend or invest recklessly on grounds that, if things went wrong, they could be bailed out by the government. Others argued that the move was necessary for broader financial stability. Some said that the Bank of England might have made things easier for banks generally if, like the ECB or the US Federal Reserve, it had injected liquidity earlier into the system.

The Bank of England’s support was unable to assuage depositors’ fears for their deposits; hordes of customers withdrew their savings from Northern Rock. A few days later, the Chancellor offered an unprecedented and legally binding guarantee of all funds deposited with Northern Rock, something that it would not easily be able to extend to the entire banking system.

More crisis reactions

Northern Rock’s problems were regarded by some as evidence that the tripartite system of regulation –between the Bank of England, the FSA and the Treasury – had not worked effectively. It had not been clear who was in charge. There was clear need for a proper system to resolve stressed banks, and there was a feeling in the Bank of England that its financial stability role needed to be made clearer. After the Banking (Special Provisions) Act was passed in February 2008, Northern Rock was taken into public ownership and Bradford & Bingley was similarly resolved, with the transfer of its retail deposit business and its branch network to Abbey–Santander.

The Banking Act 2009

The Banking Act 2009, which came into effect in February of that year, introduced a much-needed permanent resolution framework. The Act gave the Bank

of England a statutory responsibility to protect the stability of the UK financial system, and created a Financial Stability Committee to oversee this aim. The Act meant that the Bank, with the FSA and HM Treasury, would provide greater protection for investors.

The Act designated bank resolution powers, the Special Resolution Regime (SRR), to the Bank of England and other authorities to transfer all or part of a bank to a private sector purchaser, or to a bridge bank, a subsidiary of the Bank of England, pending a future sale. At HM Treasury's decision, a bank may be placed into temporary public ownership. The authorities may apply to put a bank into the Bank Insolvency Procedure, which is designed to allow for rapid payments to depositors insured under the Financial Services Compensation Scheme, and may apply for use of the Bank Administration Procedure to deal with a part of a bank that is put into administration.

The Banking Act 2009 protects creditors and counterparties, and ensures that no creditor of the failed bank will be penalised by the application of a partial property transfer compared with what the creditor could have expected if the whole bank had been placed into immediate liquidation.

In addition, the Act has given the Bank statutory authority for UK payment systems, making sure they are reliable and so contributing to financial stability. This enhances the previous system of informal oversight, and brings the Bank more in line with the approach of most other major central banks.

Six weeks after the Banking Act came into force, the SRR was triggered when the FSA decided that Dunfermline Building Society no longer met its threshold conditions for authorisation.

In its *Annual Report 2009*, the Bank of England said that it believed the creation of the SRR was a significant development but that some concerns remained that the legislation might not go so far as necessary in terms of the Bank's influence in triggering the regime and in giving the bank timely and full access to the data that it would require.

International regulation

The Bank of England is involved in moves to strengthen the macro-prudential framework, including in some of the G-20's work.

The Bank will implement high-level principles for coordination on cross-border crises, proposed by a small group of supervisors and central banks that it has chaired. The group was formed on the recommendation of the Financial Stability Forum in 2008.

Liquidity provision

Special liquidity scheme

The Bank of England's Special Liquidity Scheme (SLS), introduced in April 2008, aimed to improve the banking system's liquidity. The scheme allowed banks and building societies to swap, for up to three years, their high-quality mortgage-backed and other securities, which were illiquid, for UK Treasury bills.

It was not free of charge. All institutions that utilised the SLS had to pay a fee based on the London Interbank Offered Rate.

The drawdown window to access the scheme closed – after an extension – on 30 January 2009. The scheme remains in place for three years, providing participants with continuing liquidity support.

There has been substantial use of the scheme, amounting to £185 billion in Treasury bills, with the securities held by the Bank as collateral having a nominal value of £287 billion at 30 January 2009. Much of the collateral received was in residential mortgage-backed securities or mortgage-backed bonds.

Discount window facility

The SLS had addressed the illiquid assets held on balance sheets up until 2007, but banks and building societies still faced difficult financing conditions. In October 2008, the Bank introduced a permanent Discount Window Facility, as one of various changes in money markets operations enabling banks to swap high-quality illiquid assets, which were not required to have been on balance sheets before a particular date, for gilts or sometimes for cash. It was a form of liquidity insurance to the banking system.

In January 2009, the Bank, in acknowledgement of continued stresses in financial markets, extended this facility, for an additional fee, from the initial 30-day period to operate for up to 12 months from January 2009.

Long-term repo operations

Since December 2007, and particularly since September 2008, the Bank increased its three-month lending and has allowed a wider range of collateral. The Bank has consulted over making these arrangements permanent.

Asset purchase facility

In January 2009, the Chancellor of the Exchequer authorised the Bank of England to establish an asset purchase facility to buy high-quality assets financed by the issuance of DMO Treasury bills.

In March that year, he authorised the MPC to use this facility for monetary policy purposes. This involved asset purchases by the Bank, financed by creating money rather than by through Treasury bills. This overall process was known as quantitative easing. The MPC then voted to undertake a £75 billion asset purchase programme, financed by issuing central bank reserves.

The Bank of England Asset Purchase Facility Fund (APF), a subsidiary of the Bank, would undertake the asset purchases, with the government providing an indemnity to cover any losses arising from the facility. On this basis, the APF could buy gilts and high-quality private-sector assets, including commercial paper and corporate bonds.

By the end of November 2009, the Fund had bought nearly £180 billion of assets, mainly gilts. As the third edition of this book went to press, the APF was authorised by the MPC to purchase up to £200 billion of assets by February 2010.

Quantitative easing

Quantitative easing involves the electronic creation of money to buy assets, and is sometimes described as ‘printing money’, although it is nothing of the sort. In its own literature, the Bank of England has explained quantitative easing as follows: ‘The Bank buys assets from private sector institutions such as pension funds, insurance companies, overseas investors or other non financial firms, and it credits the seller’s bank account. This way the seller has more money in its own bank account and its bank holds a corresponding claim against the Bank of England, which is known as reserves.’

In a March 2009 interview with the BBC, Mervyn King, Governor of the Bank of England, said that the aim of quantitative easing was to ‘increase the money supply in the economy’. Six months later and subsequently, the verdict on how well quantitative easing had worked, either in the United States, or subsequently in the United Kingdom, was mixed. The economy had survived; the money supply, as measured by indicators, had not always risen to the levels predicted by the central banks; and banks were still sitting tight on their cash.

Helping the government packages

The Bank of England, along with the FSA and HM Treasury, helped the Government to design and implement two main packages to invest in and stabilise banks.

The first was in October 2008, when the Government announced it would be investing in UK banks and building societies to help stabilise their position and support the economy. This way it took major stakes in RBS and Lloyds TSB. The second package was in January 2009, when the Government announced measures which included offering loss protection on some assets.

Profit from the crisis

The Bank of England, unlike some of the financial institutions it has helped, has found the crisis extremely profitable. In May 2009, the Bank of England's *Annual Report* announced that it had made its biggest profit since it was founded in the late 17th century. The Bank had made £995 million in pre-tax profits in the year to 28 February 2009, up more than five times on the £197 million earned in 2008. After tax was paid, half the proceeds were to be returned to the Treasury as dividends and the other half was transferred to the Bank's reserves.

The profits were substantially due to the unconventional policy measures used in the previous year. In the crisis, the Bank has lent far more money than before. There was a post-tax surplus of £573 million in relation to the Special Liquidity Scheme. The Bank of England said at the time that it had made profits as a result of policy decisions to address the financial crisis.

The future

The Bank of England's strategic priorities for 2009/10 include bringing inflation back to the 2 per cent target; enhancing the sterling monetary framework to enable the Bank to provide liquidity to the system; discharging the Bank's enhanced role for financial stability; and strengthening cooperation and communication between central banks.

In the near future, the Bank of England may become more powerful. Many argue that the Bank of England has a better understanding than the FSA about what happens in the financial markets because of its responsibility for monetary policy and its role as lender of last resort. They note that the FSA was an inadequate supervisor of some of the more complex areas of banking that had contributed to the credit crunch.

The Conservative Party has made it clear that, if it comes to power in 2010, it will give the Bank of England prudential supervisory powers over banks and other significant financial institutions. For more about this plan, see Chapter 22.

Commercial banking

Introduction

In this chapter, we shall look at the activities of commercial banks, which take deposits, lend money, and participate in the money markets, foreign exchange and trade finance. We shall look briefly at building societies. We shall scrutinise how commercial banks raise capital, organise credit collection services, and address the issues of bad debt, capital adequacy and the Basel framework. We shall take into account implications of the recent credit crisis.

Overview

Banks collect money as deposits and lend money to companies. If a bank lends money, for example, toward a 25-year mortgage, the average depositor does not deposit money for so long a period, so the bank needs to find a balancing source of capital. It must keep some money with the Bank of England, and will borrow in the money markets, or longer term, through the bond markets.

This is how banks have always worked, but problems arose in 2007 when the US sub-prime mortgage problems dried up the bond markets and money markets, a situation that brought Northern Rock and some other banks to the brink of collapse. In this chapter, we will look in more detail at these recent developments. We will start, however, with a history of banking.

History

The original purpose of banks was to stash cash. The earliest bankers operated in Florence from the 14th century, and conducted business from benches in the open air. The Italian word for bank is derived from *banco*,

which means bench. If a bank was liquidated, its operation was broken up, hence the word bankrupt.

In the late 14th and early 15th centuries, some Italian merchants from Lombardy came to London, and set up as money lenders in Lombard Street, the part of the City of London where banking activities are still largely concentrated, although they have also extended to Canary Wharf. British banking started in the 17th century, with rich merchants storing their money in the vaults of goldsmiths because these premises were secure. They were encouraged to seek safe custody for their assets when, in 1640, King Charles I seized private gold deposited in the Tower of London to pay an English army which he was raising against Scotland, where he was also king.

By 1677, there were 44 goldsmith bankers in London. They would provide a receipt for money deposited, which was initially used to regain the full sum, but subsequently became assignable and so a primitive form of banknote. Clients could write a note directing money to be paid to another, the earliest form of cheque. A merchant would write an authority to his goldsmith to pay his commercial obligations. The goldsmiths used cash and precious metals deposited with them to lend money to merchants, with the aim of receiving it back plus interest, following completion of a voyage. It gave rise to the phrase 'when my ship comes home'. By offering such credit facilities, the goldsmiths were operating like banks.

Banking outside London and Italy was almost nonexistent in its modern form until the mid-18th century, but by 1810 had grown to be represented by 650 banks. By 1900, London had become the world's largest banking centre, with about 250 private and joint stock banks. During the First World War, the banking business expanded in size and scope, but it was hit by poor interwar trading conditions. During the Second World War, banks became subject to foreign exchange controls and lending priorities. In the 1950s, these started to be relaxed and banks expanded.

In the late 1960s, there was merger activity. In 1968, National Provincial Bank and Westminster Bank merged to create the National Westminster Bank. In 1969, Barclays acquired Martins Bank, the largest UK bank to have its head office outside London. In 1970, the Royal Bank of Scotland's subsidiaries in England and Wales, Williams Deacon's Bank, Glyn, Mills & Co. bankers of London, and the English and Welsh branches of the National Bank of London, merged to form Williams & Glyn's Bank.

In the 1970s, the bank manager had not changed much from Victorian times. He was a constant, fatherly and reassuring figure, and his bank would not be competing with others for business. Customers stayed with their bank, and if they knew their bank manager, could get an overdraft and investment advice. Many people did not need a bank account because they were paid in cash.

From the 1980s, banks became more competitive, and computers made the bank branch manager less of a focal point. Advice turned into sales, and the bank became a shop window for financial products. Banks and building societies started to compete across financial services. Many building societies, such as Halifax and Abbey National, demutualised and converted to banks. This in turn led to consolidation. Some larger banks bought demutualised insurance companies.

According to International Financial Services London (IFSL: McKenzie and Maslakovik, 2009: 5), at the end of March 2008 there were 324 authorised banks in the United Kingdom, including 250 foreign banks physically located in the United Kingdom. The total value of UK commercial bank lending was £6,400 billion at the end of 2008 and the outstanding level of mortgage lending was at near record levels despite turbulence in global credit markets, it reported. There was, however, a gradual decline in net lending for mortgage finance in 2008. UK residents had £7,100 billion on deposit at the end of 2008, up 12 per cent on the previous year, of which about 45 per cent was held in domestic banks.

Banking is now very international, and of the approximately 200 members of the British Bankers' Association, only about 20 are British banks. Some of the large banking groups such as HSBC and Barclays still have investment banking activities, and this can stabilise the group's retail banking activities through diversification.

Retail banking

Over the past 30 years, retail banking has developed dramatically and takeover activity has made the industry more concentrated. In October 1989, Midland Bank set up First Direct as the first telephone bank, with a 24-hour, 365-day service, and many were sceptical about whether it would last. The launch was accompanied by different advertisements run on different television channels, showing a negative view of normal banking compared with a positive view of First Direct. By May 1991, the bank had 100,000 customers on its books, by March 1993 it had 250,000, and by April 1995 it had 500,000 customers. In August 2000, First Direct said it would move into internet banking.

From the 1990s, other banks followed suit. They closed traditional branches to move in the direction of telephone and subsequently internet banking. The trend was towards electronic centralisation as local industries collapsed, forcing workers to find jobs in another town, taking their bank accounts with them.

The major high-street commercial banks today provide face-to-face as well as internet banking services, and operate as mini-financial conglomerates. They can provide financial products, which may be *own brand*, or if the bank operates on a multi-tied basis, from a number of providers (see Chapter 31).

Banks in the United Kingdom have a reputation for being more user friendly and flexible than those in continental Europe, which sometimes pay very small interest on credit balances in some current accounts. In the United Kingdom, people who are a good credit risk can arrange an overdraft easily and quickly, compared with other countries, where people typically have to set up a specific credit facility for the purpose.

Banks offer a ‘cash machine’ card, which has a magnetic strip enabling owners to withdraw cash to a maximum sum from an automated teller machine, known as an ATM, in the high street. This card can also serve as a debit card, which is effectively an electronic cheque. Purchases made this way will be debited to the customer’s account a couple of days after the transaction is made, in the same way as a traditional cheque.

Banks handle credit cards through a separate credit card arm. They might have their name on the card, or it might represent the next layer, which is another institution issuing cards. The market is competitive. Visa or MasterCard process the transactions, acting as clearing organisations. The card issuers make their profit mainly from interest charged to users, but also from fees that retailers pay to offer the credit card option to their clients. Charges must first cover bad debts, card thefts and fraud.

Today, banks operating in London can be British, German, French, American or from other countries. The international nature of banking has meant new types of risks for UK depositors of money with institutions in jurisdictions outside the United Kingdom. See Chapter 34 for details on how UK depositors put their savings in Icelandic banks which ran into problems.

Banks are not just international; their activities are also wide-ranging. They take deposits and do other work traditionally associated with commercial banking, including fund management, trade finance, leasing and factoring, venture capital, project finance – meaning huge one-off projects such as the Channel Tunnel, syndicated loans and foreign exchange. Some also do investment banking (see Chapter 7).

Convergence between commercial and investment banking has always attracted controversy. US politicians and financiers blamed it for the great crash of 1929. The US Congress duly passed the Banking Act of 1933, the Glass–Steagall Act, which separated the two types of banking. Recent opinion has been that securities trading need not harm commercial banking, and in 1999, Congress passed the Financial Services Modernization Act, which eliminated the separation between the two types of banking.

During the financial crisis of 2007–10, the UK Conservative opposition party initially called for a return to this style of separation, but then abandoned this position.

Critics say that a Glass–Steagall style of separation would not have prevented the run on Northern Rock (discussed later in this chapter) or the collapse of Lehman Brothers. Commercial and investment banks, even when operating separately, traded asset-backed securities off their balance sheets. This enabled them to take on huge leveraged debts without having the amount of regulatory capital that would otherwise be required, although changes to the Basel II framework are being introduced to eliminate this anomaly.

Commercial banks in operation

Commercial banks are mainly involved in deposit taking and lending. Deposits build up when people leave surplus money in saving accounts. When banks lend money to their clients, it comes from other banking clients, as well as from the money markets or bond markets. In effect, what goes into one person's account as a loan may come out of another's account.

Banks pay a small rate of interest on cash deposited, and lend out money typically at a much higher rate, making a margin on the difference. In common with the government, they keep bank accounts with the Bank of England. A bank must retain a required level of liquidity, and it can borrow or lend money wholesale on the money markets (see Chapter 11), dealing with other banks or perhaps multinational companies. Every night, a bank may offer surplus funds for overnight loans, or it may borrow funds, perhaps because a large number of customers drew down significant sums that day.

The banks lend to consumers, which is known as retail banking, or to businesses and governments. Companies borrow more than retail customers and negotiate a better rate, which the bank endeavours to offer through its money market operations. On a bank's balance sheet, deposits are liabilities because the bank owes money to customers. Any sums that banks lend, both from deposits and from wholesale funds that they have borrowed, are assets because they ultimately belong to the bank.

The banks lend out a proportion (perhaps two-thirds) of the money deposited at any given time. The system is known as fractional reserve banking, and it works on the assumption that depositors won't rush to withdraw their money all at once. This is normally a reasonable assumption.

The exception is when there is a run on the bank and widespread panic, as happened in the September 2007 run on Northern Rock. This mortgage bank had a business model that relied on wholesale markets to fund its mortgage lending, but these had seized up, making it more dependent on its retail deposits. In a panic about whether their money would be secure with Northern Rock,

customers rushed to withdraw it. The government stepped in to restore confidence, and in September 2007 it guaranteed all deposits made with the bank.

There was not much surprise when, in February 2008, the government announced it would nationalise Northern Rock. In late September, it said that it would partly nationalise Bradford & Bingley, another troubled mortgage lender. In October, the government announced a £25 billion bailout of major UK banks and that it would provide capital support in return for a stake in them. Some rejected the proposal, with Barclays announcing a plan to raise £6.5 billion independently, but as an upshot, the UK government now has a 70 per cent stake in Royal Bank of Scotland, and a 43 per cent stake in the Lloyds Banking Group. The government's stakes have sent out a message that banks will not be allowed to fail.

Some commentators have advocated breaking up the banking system so no individual bank is too big to fail. The aim would be to create a situation where banks would not be tempted to take excessive risks because, if their plans should go wrong, they could not rely on a government bailout.

There is little disagreement that banking now has to return to basics. The price to pay could be less innovation and risk, and lower profits. For how long that could prove acceptable to society in general, and those concerned with maintaining London's competitiveness as a financial centre, remains uncertain.

Structured investment vehicles

Shadow banking is about non-bank financial institutions that operate like banks but, unlike banks, lack deposit insurance protection and the support of a central bank as lender of last resort.

The shadow banking system includes structured investment vehicles (SIVs), which banks may sponsor and control without owning them. The SIVs issue short-term commercial paper or bonds in the wholesale markets at a low interest rate. They lend out the money they receive, buying long-term securities or corporate receivables at a higher rate than that at which they issued the paper. It is through the difference in rates that the SIVs make their profit. The banks that set up the SIVs may extract some of this profit as fees.

In short, SIVs operate like banks, but they have more volatile market exposures. The SIV may have to pay out on the commercial paper issued before the long-term money is due, and will try to refinance the short-term debt at a sufficiently low rate; if that proves impossible, it may have to sell the longer-term securities into a difficult market. If the commercial paper pays higher interest than the long-term securities, the SIV risks insolvency. This happened during

the credit crisis after the market for commercial paper dried up. In some cases, the sponsoring bank stepped in to prevent such failure.

During the credit crisis, the banks used SIVs to put risky investments off their balance sheets and so avoid the capitalisation requirements that would have applied under Basel I, the earliest version of the Basel Accord. They transferred the risk exposure to shadow banking. In practice, banks sometimes voluntarily supported SIVs with liquidity lines or later brought lending through SIVs back onto their balance sheets.

In 2007, the UK Treasury found that Northern Rock, which it was rescuing from collapse, did not own half its mortgages. Some of them had been removed to Granite, a Jersey-based SIV, which allowed the bank to trade risky securities without having to be backed by required banking capital.

Some regulators now argue that Basel II, the latest version of the Basel Accord, would have reduced the impact of the credit crunch if it had been in place earlier. Basel II puts a capital charge on the liquidity guarantees that some banks give to off-balance-sheet vehicles. We shall look at Basel II in more detail towards the end of this chapter.

Building societies

Building societies are lending and saving institutions, and compete with banks. As at the end of May 2009, there were 52 building societies across the United Kingdom, with assets of over £375 billion. As mutual organisations, they are collectively owned by their members. A building society is not allowed to raise more than 50 per cent of its funds from wholesale markets. On average, it raises 30 per cent of its funds this way, which is partly why building societies were less exposed to the credit crisis starting in 2007 than banks.

According to the Building Societies Association, the societies often offer better-value products than the banks, particularly in savings accounts and retail mortgages, because they do not have to use around 35 per cent of their profits to pay dividends. In some cases, building societies may make their products available to people living within a certain, relatively small, geographical area.

Building societies serve about 15 million savers and over 2.9 million borrowers. They hold mortgage assets of almost £250 billion, more than 20 per cent of the total outstanding in the United Kingdom. On the savings side, they hold over £235 billion of retail deposits, accounting for more than 20 per cent of all those in the United Kingdom, but a much higher 37 per cent of cash-based individual savings accounts (ISAs) (see Chapter 31).

The Building Societies Act 1986 made it possible for a building society to convert itself into an investor-owned company. Managers and directors favoured this demutualisation to boost their own incomes; *carpetbaggers* sought windfall profits by opening temporary savings accounts in the societies most likely to convert.

The downside was that borrowers from the newly formed banks could lose because lending rates could rise. Demutualisation has, however, enabled the converted entities to tap into traditional banking markets, including the commercial lending and money markets. There has been no restriction on how the demutualised entities can raise money or on products offered, which has provided opportunities to gain scale to compete with banks.

All the same, demutualisation has not been an unqualified success. Between 1989 and 2000, 10 UK building societies became banks. Not one of them remains an independent company. In 2000, Barclays bought the Woolwich, and in 2001, Halifax merged with Bank of Scotland to form HBOS, which, in January 2009, joined with Lloyds TSB to create Lloyds Banking Group. In 2004, Banco Santander Central Hispano, a Spanish financial group, bought Abbey, and in 2008 it bought Alliance & Leicester. Others sold themselves directly to banks. Cheltenham & Gloucester is now owned by Lloyds Banking Group and National & Provincial by Santander. Bristol & West is owned by Bank of Ireland and Birmingham Midshires is owned by Lloyds Banking Group. There is talk of consolidation among the remaining building societies.

Now that we have seen the basics of how banks and building societies work, let us focus on how the banking system provides capital.

Raising capital

General

Uncommitted finance is the term for a bank providing finance facilities to businesses, but not being committed to allowing money to be drawn at a particular time. This could involve any form of finance, including a loan, perhaps in the form of a term loan.

Committed finance applies to business and personal accounts. In this case a bank commits itself to providing capital through a formal agreement or structured fee payment. The bank might say, 'We'll lend you £10,000 for five years, at a given interest rate, with fixed fees payable, and an agreed procedure if you fall behind with payments.' A committed facility need not be a loan, but could be a guarantee or a letter of credit. For example, if a local authority gives a

contract for work, it may require a guarantee from the contractor's bank that if things go wrong, it will get its money back.

The overdraft straddles uncommitted and committed facilities. It is used both for business and personal accounts. A bank can arrange an overdraft quickly and informally; it will agree a limit, and the customer will pay only for money borrowed. Daily interest on the overdrawn balance may be set at a margin over the base rate or, typically for personal accounts, at a managed rate.

The syndicated loan

If a borrower wants more money than an individual bank will lend, a syndicated loan may be used to spread the loan across a number of banks. It will probably be for more than £50 million, and possibly for hundreds of millions of pounds. If the borrower breaches its covenants under the loan agreement, the banks will be released from their commitment to provide financing.

Project finance

A commercial bank may fund a large-scale infrastructure project, such as an oil pipeline, through recourse lending. A recourse loan means that if the borrower should default, the endorser or guarantor of the loan has a secondary liability.

Investment bankers may finance projects with non-recourse lending, where the lender does not seek repayment from the borrower personally, but is paid from some other sources, for example, the asset's income stream.

In both recourse and non-recourse lending, the lender will require the project itself to repay the loan. It will assess the project's viability in terms of future cash flows; these may be guaranteed through a government contract to use the products or services generated by the project. The bank is likely to ensure it will be paid first by having a charge over escrow accounts into which income from the project must be paid.

Commercial banks provide some of the funding for projects in developing countries. Multilateral lending agencies – such as the European Bank for Reconstruction and Development – finance projects intended to benefit the infrastructure of such countries.

Asset finance

According to the Finance & Leasing Association (FLA), asset finance from banks has overtaken bank loans as the main source of finance for capital purchases up to £100,000. The three main types are finance lease, operating lease and hire purchase. Asset finance can reduce pressure on the borrower's cash flow, enabling payments to be spaced out, and repayment terms may be customised.

Finance leasing is where the bank buys an asset and gives use of it to a company at an agreed rate over its whole economic life, with ownership usually remaining with the finance provider. The risks and rewards will have passed to the lessee. The lessee must treat this arrangement as an asset on its balance sheet, and it will be depreciated over its life. The bank can claim capital allowances on the assets it leases out, and will have a charge over them. For these reasons, it can offer the company a good rate of interest on the leased asset.

Operating leases, unlike finance leases, are for only part of the economic life of an asset. They do not provide the benefits of ownership, given that the risks and rewards of ownership have not been passed to the lessee.

Hire purchase involves finance for the whole economic life of an asset, but ownership ends up with the client. The accounting treatment is similar to that of finance leasing.

Lease accounting is under discussion. The International Accounting Standards Board and the Financial Accounting Standards Board in March 2009 published a discussion paper focused on putting all types of leases on firms' balance sheets. According to the FEA, this would make a significant difference to how several million businesses would account for leases on all types of assets. The trade body is concerned about the potential complexity of the regulations.

Credit collection

Banks are involved in guaranteeing and collecting credit, as well as providing it. Let us see how they provide these services.

Trade finance

When a UK exporter of a product has found a buyer overseas, it commits itself to delivering the product and the importer commits itself to paying. The exporter shares its bank documents with the importer to confirm that the product has been put on transport for delivery and is of the specified quality, and the importer will either have funds in its account or will have made other financing arrangements.

The exporter will ask the importer to arrange a letter of credit (LOC) from the importer's bank. If the importer's bank agrees to issue the credit, it will send it to the exporter through the exporter's bank. The LOC will stipulate the documents required and any relevant timescales. At the time the goods are dispatched, the exporter will present the LOC to its bank together with the required documents. If all is in order, the exporter's bank will then pay the exporter under the terms of the LOC and claim reimbursement from the importer's bank.

Where an LOC is not involved, the collection of bills or documents works as follows. The exporter presents documents, usually with a bill of exchange, to its bank with instructions to send these for payment to the importer's bank, of which the importer will have provided details. The exporter's bank will proceed accordingly, presenting the documents as a request for payment to the importer's bank. On the importer's authorisation, the bank will send the money to the exporter's bank, which will then credit the exporter's account, less any charges.

Asset-based finance

According to the FLA, asset-based finance describes products such as factoring, invoice discounting and asset-based lending.

In factoring and invoice leasing, a business sells its invoices to an invoice financier when they are issued. In invoice discounting, the client maintains control of the sales ledger, and factoring is where the invoice financier takes over. In either case, the bank pays the business up to 90 per cent of the invoice value in cash immediately, and the rest, excluding charges, following a set period or once the debt has been collected.

Asset-based lending is funding against a range of corporate assets, including stock, plant and manufacturing. Users are typically multinational corporations.

According to the Asset Based Finance Association (ABFA), the asset-based finance industry has continued to grow during the financial crisis, and by the end of 2008 it was advancing more than £17 billion to UK businesses. The use of export invoice accounting rose 24 per cent in 2008, indicating that more businesses were looking overseas to find new contracts, which the ABFA suggested was perhaps in an effort to move away from the slowdown in the United Kingdom.

Bad loans

Bad loans happen as a small proportion of all loans a bank makes. In the case of certain very large loans, there have been repayment failures, particularly from developing countries. If a syndicated loan to a country cannot be repaid on time, banks may restructure the borrowing to avoid the country being declared bankrupt, but it can lead to an international crisis and harm the global economy. If a default gets too deep, banks may feel forced to declare the loss. In May 1987, Citicorp declared a US\$3 billion provision against loans to third-world countries, which amounted to public acceptance of a loss. Other banks then announced provisions against similar losses.

More typically, a bank may make a specific provision on its balance sheet against a bad or doubtful debt, for example where an identified customer is

unable to meet an obligation to pay a specified loan. There may also be a general provision; if, for example, a mine closes in a small town, people will lose jobs and the local bank will know that some loans will have to be written off, but not which ones specifically. The bank will raise a general provision against, perhaps, 10 per cent of the money it has lent.

Following the peak of the credit crisis and the UK government bailout of some banks in late 2008, banks were required to hold more capital, and some sought to raise it through rights issues. The need to hold more capital against loans is one reason why banks are not lending as much as they might. There is also a greater risk in lending to businesses in the recession.

Capital adequacy

Banks need to have sufficient liquidity and capital to see them through difficult times. In the United Kingdom, the FSA authorises and supervises banks, and it has set capital adequacy requirements for them, based on the latest best-practice recommendations of the Basel Committee for Banking Supervision, as the standard-setting body within the Bank for International Settlements, which serves as a bank for central banks. The committee consists of regulators and central bank officials from 10 major global economies, known as the G10 (plus Spain and Luxembourg). As the 2007–10 financial crisis has shown, not only was Basel I, the first Basel Accord, inadequate, but a bank can be in difficulty through lack of liquidity even when there is no breach of capital adequacy requirements or immediate threat to solvency. Northern Rock was in this position.

Basel II was made law in the European Union by the Capital Requirements Directive. It is intended to reduce the possibility of consumer loss or market disruption as a result of prudential failure. To achieve this, the Accord seeks to ensure that financial resources held by a firm are commensurate with the risks associated with its business profile and internal control environment. Basel II is a more advanced version of Basel I, the first stage of the Basel Accord, which required banks to keep a minimum 8 per cent level of regulatory capital as a proportion of assets weighted by credit risk, and was subsequently amended a few times, including measures to cover market risk. Basel II retains the same minimum capital-to-assets ratio, and the buffer capital in the banking system must not be permitted to fall below levels required under Basel I. In practice, all solvent banks hold more than the minimum capital.

Under Basel II, banks may use a more advanced way of measuring their risks, and if so, they may have lower capital charges than banks using the simpler approaches. The capital charge is based not on the type of issuer, as under Basel

I, but on the rating of the debt, which has thrust credit rating agencies to the heart of the bank capital system. In practice, only a few major banks use the advanced approach, the rest using the standardised approach, which is a more risk-sensitive version of Basel I.

The intention for Basel II was that, as a result of greater risk aversion, institutions could price more keenly. In practice, the models on which the system was based turned out to be incapable of predicting the frequency and size of major adverse events. The limitations of these, and any other, models have become painfully apparent in the financial crisis. Basel II requires banks to hold capital against off-balance-sheet exposures. Part of the problem was that US banks had not yet implemented Basel II. Another criticism is that Basel II is too complicated and expensive, and may benefit larger banks more than smaller ones. Banks may be reluctant to lend to small businesses because they represent a significant security risk. On the flip side, the strict requirements for covering risk may inculcate a false sense of security.

A major further criticism of Basel II, which has emerged since the credit crisis, is its procyclical effects. This is directed against the advanced way of measuring risks. As borrowers become less creditworthy in the course of a recession, Basel II, unlike Basel I, can require banks using the advanced method to hold more capital.

According to the *Turner Review* (2009a), an influential set of proposals produced by the FSA's chairman Lord Turner in March 2009, regulators should take immediate action to ensure Basel II implementation does not create unnecessary procyclicality. In addition, it should introduce a counter-cyclical capital adequacy regime with capital buffers that increase in economic upswings and decrease in recessions.

In the second half of 2009, the Basel Committee was working on revisions to the Basel II framework, including overall capital levels to be required of banks, a capital surcharge on large banks, capital to be held in relation to the trading books of banks, and counter-cyclical capital. There was talk of introducing the revisions in phases. The FSA, as agreed at European level, had meanwhile put in place an interim new capital framework for banks; at the same time stress-testing exercises were conducted in October 2008. Banks had to hold a 4 per cent minimum level of core tier one capital after the impact of the stress tests, which was double the amount required by the Basel framework. Where necessary, the government provided a capital injection.

The financial crisis

The commercial banking sector has been hit hard by the financial crisis. The nationalisation or recapitalisation of several banks and mortgage lenders could cost the taxpayer £50 billion. Securitisation market activity became, in practice, confined mainly to central bank repurchase schemes. There is a widespread view that things will eventually recover, but not until consumer confidence comes back. There is a mood of cautiousness.

The mistrust that commercial banks had incurred gave retailers an unusual opportunity to gain market share. Tesco was in the lead and, in mid-2009, was pioneering in-store banking. There is, however, a long way to go. How far retailers, with their unconventional business model, can succeed in banking over the long term remains to be seen.

Introduction to equities

Introduction

Much of this book is about institutional investors, which are responsible for the vast majority of investing by value. In this chapter, which focuses on equities, we shall assume the perspective of the private investor.

We shall look at the mechanics of the stock market, including how nominee accounts work, and indices. We also focus on the different types of stockbroker.

Shares

Shares are a type of security that represents ownership in a company. The word ‘equity’ is often used interchangeably with ‘stock’ or ‘share’, which signifies the investor’s share of ownership. Once a company is quoted on the London Stock Exchange (LSE), or any other exchange or trading facility, including abroad, you can usually buy and sell shares in it, which is most often done through a broker. Shares can rise or fall in value, which is reflected in a fluctuating share price. The price is set as a spread between a buying price, which is above mid-price level, and a selling price, which is below it.

Many companies quoted on exchanges pay a dividend, which in the United Kingdom is paid twice a year. This represents a payment from corporate profits to shareholders. The share price is likely to rise a little as the dividend day approaches, and fall subsequently. Dealing on or after the ex-dividend date will be at a lower price because it excludes the dividend entitlement.

By owning a share, you are a part-owner of the company, and may attend an annual general meeting (AGM). The AGM is a statutory requirement and it offers you as a shareholder the chance to review the company’s activities. You also have voting rights.

If you are a private investor, you will often need to hold your shares for at least several months, and perhaps some years, to gain profit from your investment. Traders go in and out of stocks within a much briefer period and so base their investment decisions on more short-term factors.

Shares are now usually held in electronic form through nominee accounts, although the old-fashioned paper share certificates are still used to a limited extent. Investors have their shares registered in the name of a nominee company but retain beneficial ownership. The account is run by their broker. Investors do not lose access to shareholder perks and voting rights, but it is up to the nominee company to provide them with the relevant information. Dividends are paid and regular account statements are provided.

The industry standard for settlement of share transactions held in nominee accounts is T + 3, meaning that both counterparties to a trade agree to settle a trade three business days after the trade date, although market makers, as opposed to the electronic order book, can offer some flexibility. For paper share certificates, it is T + 10.

Some private investors dabble on a one-off basis in the stock market, but for those with a more sophisticated approach, the conventional wisdom is to build a diversified portfolio, investing in a number of companies, each in a different sector. This way, the risk is spread. If one share falls in value, the others may outperform, balancing out overall performance.

On a broader scale, investments may be diversified across assets and countries. Bonds are less risky assets than equities, and cash deposits are the safest asset class of all. Commodities and property will broaden the spread of risk. In normal times, Western Europe is a more stable environment in which to invest than emerging markets such as China and India, but it has less growth rate potential.

Investors take long and short positions in shares and other assets. A long position is where they own a share and expect to sell their position in the future at a profit. If they go short, they will sell a stock they do not own with the aim of buying it at a lower price before settlement, so making a profit on the price difference.

The rolling settlement system makes it difficult for private investors to go short on shares. But they can take a short position using contracts for difference, covered warrants, or spread betting (see Chapter 9).

If an investment bank has a net short position in a stock, it may borrow from a lender to deliver the securities on the agreed settlement date. From the buyer's perspective, there is no practical difference between borrowed and owned stock. If the bank has a net long position, it may lend the stock to borrowers for a fee.

As a result of short trades, stock lending flourishes in bull markets, and improves market liquidity. Stock lending figures, available from Euroclear UK

& Ireland and other sources, provide only a very loose indication of short-selling levels, as other factors must be considered as well.

Market indices

If you want to see how the broad market, or a part of it, is performing at any given time, you will look at market indices. The indices can serve as a benchmark against which to buy or sell individual shares or a portfolio.

The most widely quoted index is the FTSE-100 Index, which covers the largest 100 stocks listed on the LSE by market capitalisation (share price multiplied by number of shares in issue). FTSE-100 companies, referred to as blue chips, each have a market capitalisation that may be several billion pounds or more, with wide variations. The index represents about 81 per cent of the UK market.

The FTSE-250 Index includes the next 250 stocks by market capitalisation behind the FTSE-100. It represents about 15 per cent of the UK market capitalisation. Companies on the FTSE-250 are large enough to survive hard times, but have more room for growth than the blue chips.

The FTSE-100 and the FTSE-250 together make up the FTSE-350 Index. An even broader measure of the whole market is the FTSE All-Share Index, which includes the 700 largest shares on the LSE, representing 98–99 per cent of UK market capitalisation.

Companies too small to be included in the FTSE-350 may be in the FTSE SmallCap Index, accounting for about 2 per cent of the UK market capitalisation. Stocks in the FTSE-350 and the FTSE SmallCap Index make up in its entirety the FTSE All-Share Index series. The FTSE Fledgling Index consists of companies too small to be included in the FTSE All-Share Index, but all of them will have achieved a full listing on the LSE, with a market capitalisation that can be as little as £500,000, but is usually at least a few million pounds.

Smaller companies may choose to be listed on the LSE's Alternative Investment Market (AIM), and these are represented in the FTSE AIM Index. Some smaller companies are PLUS-quoted (see Chapters 6 and 16). Very young companies may be unquoted, as they would more likely be seeking venture capital. Institutional investors do not always give a lot of attention to small stocks because they are hard to trade in large quantities. The banks and stockbrokers research them less. But specialist funds focus on small stocks.

Small company shares are a favourite hunting ground for private investors, often guided by tip sheets (see Chapter 21). Stockbrokers note that the stocks

are volatile, have many more losers than winners and are not particularly liquid, which tends to cause problems in a market crash.

Bond prices often move in broadly opposite directions from share prices, although they sometimes move in line, and bonds are considered a less risky investment. Chapter 11 explains how government bonds work. The UK Gilts Indices are calculated by the FTSE Group and are based on all eligible British government securities, divided into conventional gilts and index-linked gilts. There are also corporate bonds, which are slightly lower risk than government bonds, as discussed in Chapter 12. In the United Kingdom, these are represented and measured in the FTSE Sterling Corporate Bond Yields Index.

Stockbrokers

There are three main types of stockbroker. The advisory broker gives advice and the discretionary broker makes decisions on its clients' behalf. Together, these two cater for around half of all private clients. The third type of broker is execution-only. Let us look at each.

Advisory

Advisory stockbrokers advise clients on which stocks to buy or sell, and when, and execute the trade. Some specialise in certain types of stock such as small growth or high-income blue chips. The service is about getting the balance right between having the clients involved in decisions and protecting them from making mistakes. Levels of expertise vary widely, and success may depend partly on the relationship between the broker and client.

Discretionary

Discretionary brokers or fund managers take full charge of an investor's portfolio, and execute the trades. They make buying and selling decisions on the investor's behalf for a fee.

Some discretionary firms have produced unfortunate results, particularly in market downturns. Some allocate too high a proportion of cash into risky assets such as equities because it pays them more in commissions, or they can over-trade portfolios.

The broker is not always to blame. The client may have indicated that it has an appetite for risk when it started the relationship. Even so, investors should make it clear that they are watching. They should ask about investment decisions, request frequent statements, and check that the broker at least cuts losses and runs profits.

Execution-only

The execution-only broker offers no advice to investors, but simply executes their orders online or by telephone. This reduces staff and other costs, and they pass the savings on to the investor. The trend towards online services, along with industry consolidation, has contributed to a steady reduction in the average commission and fees charged per transaction, according to Compeer, the benchmarking and research services specialist.

For practical purposes, in dealing with such brokers, private investors should be self-reliant and pick their own stocks. They will need to research companies and sectors in order to select shares to buy and sell. These skills are also needed to understand what an advisory or even a discretionary broker is doing.

The next step

In the next chapter, let us look at the most important data used for measuring the performance of the market and of individual shares.

How to value shares

Introduction

In this chapter, we shall see how to value shares. We shall see how analysts work. I shall define key financial ratios such as earnings per share and the P/E ratio, as well as discounted cash flow. We shall focus on what influences the market, including the biggest movers, company results and trading volumes.

Analysts' forecasts

The City is more influenced by analysts' *forecasts* for a company than by results, which are based on the past. The share price is typically based on what the company is expected to do in one to two years' time, and this perception can change.

If an analyst at a prestigious bank changes a stock recommendation from *hold to buy*, this will affect the share price on the day as traders react. The share price may overreact up or down, and often will even out later.

For more about how analysts work, see Chapter 20. Let us now see how you may borrow from analysts' techniques and value stocks.

Ratios

Financial ratios enable a quick assessment of a company against its own past or that of its peers. To understand what these ratios mean, it is helpful to know how they are made up, but you do not need to calculate them yourself. In the business pages of *The Times* (see print version), some of the key ratios and statistics are included under the two pages headed 'Equity prices'. You will find here a list of companies quoted on the London Stock Exchange under alphabetical sector

headings representing broad categories of business. The first heading is 'Banking & finance', and the last one is 'Utilities'.

Against the names of companies, of which those in the FTSE-100 Index (the 100 leading stocks) are in bold, the first column covers the high and low of the share price in the past 52 weeks; the bigger the gap, the more volatile are the shares. In Monday's edition, a column for the company's market capitalisation (share price multiplied by number of shares in issue) is provided instead.

The next column has the company's name. It is followed by the share price, which is at yesterday's closing mid-price – halfway between the buying and selling price, based on the most competitive quote. To the right is a column headed by a plus and minus, showing any share price difference in pence between yesterday's and the previous day's close. On Mondays, the share price change shown is weekly rather than daily.

Further to the right is the yield, which is the dividend divided by the share price, multiplied by 100. The higher the yield, the higher the income payments to investors as a proportion of the current share price. Some sectors such as utilities are high yielding, but growth companies typically have a low yield.

The earnings per share (EPS) is the ratio that City professionals follow most widely. It is the listed company's profits after tax divided by the number of shares in issue.

The City likes to see the company's EPS steadily rising over the years. It is worth checking out the last five years of figures to see how far this has been achieved. Be aware, however, that despite recent standardisation of accounting practices across Europe, accountants have some discretion on how they allocate profits, which affects the EPS. They will try to present the company in a favourable light. Bear in mind that earnings can be greater than cash flow because they can include items other than pure cash. As the City saying has it, profit is a matter of opinion and cash is fact.

To compare cash flow with earnings, the ideal approach is to compare the cash flow statement with the income statement in the annual report and accounts, which is usually available on a listed company's website. If net cash generated from operating activities on the cash flow statement is materially less than net operating profit on the income statement, there has been creative accounting at work, as Jim Slater put it in his book *The Zulu Principle* (1992).

Earnings per share divided by dividends per share provides dividend cover, a figure that you will be able to calculate from data provided on individual companies in the business section of *Times Online*. Dividend cover says how easily a company can pay a dividend from profits. It only applies to those stocks that pay dividends, which excludes some of the small growth stocks. A company in good financial health should be able to pay its dividend, assuming it has one,

comfortably from current earnings. If not, it may have to use its reserves to keep up the payments. As a rule of thumb, when dividend cover is less than one, there may be cause for concern.

Let us return to *The Times* (print version) share price tables, where the last column is headed 'P/E'. This is the price/earnings (P/E) ratio, which is widely used and shows how highly the market rates a company. At *Times Online*, it is called PER. The P/E ratio is the current share price, divided by the earnings per share in the most recent 12-month period. It moves in the opposite direction to the yield.

If a stock has a P/E ratio higher than its peers, the market rates it highly. The shares may be overpriced but could shoot higher, based on demand exceeding supply in the short term. If the company or market has a setback, the crowd euphoria can reverse and the share price could revert to a level closer to or below fundamental value.

If the P/E ratio is low, the market is not attaching much value to the stock's prospects, often for a good reason. But in the case of a less widely followed stock, a low P/E ratio suggests possible overlooked value.

If a technology company, for instance, has no earnings per share because it has not yet broken into profit, it will have no P/E ratio, and other valuation methods will have to be used, such as price-to-sales ratio (available at *Times Online*).

The professionals use several ratios at once, among other valuation tools, to build a composite picture of how a stock is performing. In the case of small growth companies, a P/E ratio is more useful when considered in conjunction with profit growth. If a stock has a P/E ratio of 20 and is growing at 20 per cent a year, this may represent good value, but if the annual growth rate is only 5 per cent, it could look expensive. The PEG (price/earnings/growth ratio) is the P/E ratio divided by earnings growth and so covers both these factors. It is included under company headings at *Times Online* and can be useful in valuing small companies.

The return on capital employed (ROCE) is a measure of management performance. It is calculated as profit before interest and tax, divided by year-end assets less liabilities, expressed as a percentage. Analysts favour a rising ROCE that is higher than in peer companies.

To value property companies, investment trusts or composite insurers, the share price/net asset value (NAV) per share may be used. This is the company's total assets less its liabilities, debentures and loan stocks, divided by the number of shares in issue.

Gearing represents a company's level of borrowing, or the relationship between debt and equity in its capital structure. It is most commonly expressed as debt capital as a percentage of total capital funding (that is, of debt capital plus equity capital). The higher the gearing, the greater the risk, but as a rule of thumb, more than 50 per cent is potential cause for concern.

For capital-intensive companies with large borrowings, such as in telecoms, a useful figure is earnings before interest, tax, depreciation and amortisation (EBITDA). In this type of company, EBITDA arguably presents a more realistic valuation than conventional earnings, which are calculated after interest and tax.

However, EBITDA is not recognised by accountants. Because it excludes tax, there is an obstacle in comparing stocks based on this valuation method across international borders when the respective countries' tax regimes differ, although this avoids what is seen as a distorting factor in making the comparisons.

Analysts had used EBITDA to value WorldCom, a US telecoms group, which in July 2002 made a Chapter 11 bankruptcy protection filing a month after it had revealed a US\$11 billion accounting fraud. Analysts then stopped using EBITDA as a stand-alone stock valuation tool, but still have it as a weapon in their armoury.

Analysts value companies using the enterprise multiple, which is enterprise value (EV), consisting of a company's market capitalisation plus debt, divided by EBITDA. The EV/EBITDA ratio takes debt and cash into account, which the P/E ratio does not, and it is used to find attractive takeover candidates, helpfully showing how much debt the acquirer would have to take on. Like the P/E ratio, the lower the enterprise value, the better the value of the company, although the ratio tends to be higher in high-growth industries, and comparisons should be made against the sector.

The most widely used tool of analysts, and arguably one of the most dangerous in the wrong hands, is discounted cash flow analysis.

Discounted cash flow analysis

Discounted cash flow (DCF) analysis translates future cash flows into a present value. It starts with the net operating cash flow (NOCF). You find this by taking the company's earnings before interest and tax, deducting corporation tax paid and capital expenditure, adding depreciation and amortisation, which do not represent movements in cash, and adding or subtracting the change in working capital, including movements in goods or services, in debtors and creditors, and in cash or cash equivalents. This is the year's NOCF. It can be calculated for future years, and reduced in value to present-day terms by a discount rate.

Weighted-average cost of capital (WACC) is often used as the discount rate. This represents the cost of capital to the company. It is the average of the cost of equity and debt, weighted in proportion to the amounts of equity and debt capital deemed to be financing the business.

The cost of equity, which is part of WACC, is the expected return on equity, which is most often measured by the Capital Asset Pricing Model (CAPM). The CAPM finds the required rate of return on a stock by comparing its performance with the market. It expresses this return as equal to the risk-free rate of return plus the product of the equity risk premium and the stock's beta. The beta measures the sensitivity of a share price to movements in the general stock market.

The CAPM stipulates that the market does not reward investors for taking unsystematic (company-specific) risk because it can be eliminated through diversification. The model is theoretical and is based on various assumptions, including no taxes or transaction costs. Share buyers require a higher return than debt providers to compensate for the risk, and for the fact that the company must give priority to debt repayment over paying dividends.

The cost of debt, the other part of WACC, is more transparent. It is commonly estimated as the redemption yield on the company's bonds, and interest rates on loans and overdrafts.

DCF has proved itself a flexible tool in the hands of analysts wishing to create valuations sometimes out of thin air, but it has lost credibility since the market crash of March 2000. The problem has been more about how DCF is used than with the underlying concept. You only need to change one or two of the parameters and you will get a different figure for DCF, and this leaves it open to manipulation.

To make an accurate forecasting scenario more likely, analysts may plot DCF models using different discount rates and different cash generation scenarios to present alternative valuations. The aim must be to present a prospective picture, including variables, and not to be too dogmatic, although investors crave specific numbers.

Now that we have looked at some stock valuation techniques, let us turn our attention to what influences the market.

Market influencers

The market is influenced by sector and economic news, particularly of events in the US market the previous day or in Asian markets overnight. It discounts what is known or thought will happen in the future. Investors focus particularly on the biggest movers, company results and trading volume. Let us look at each.

Biggest movers

You can obtain yesterday's main risers and fallers on the stock market from some financial websites, including from some stockbrokers. This gives you a

valuable indication of what is driving the equities market. Shares that soared yesterday are likely to have overdone it and may drop back today, or they may continue to go up – but not forever. As an investor, you need to check out the reason for the price movement so far, and assess how far it is discounted in the current share price.

Company results

The share price moves in anticipation of results. When a company reports results and they are as expected, there will not be much price movement. But if the results have a surprise element in them, it can affect the share price, particularly if there is a shock profit warning. In such a case, analysts will take time to forgive the company for not having given them a steer, and may be loath to give it a high valuation.

Company results are reported as news stories in the financial pages of the national press. Useful tables accumulate the figures in one place. In *The Times*, company results are reported in the table headed 'Results in brief'. Against the company's name and (in brackets) the sector, you will find the year or half year covered – for example 'Yr to June 30', or 'HY to August 1', the pre-tax profit or loss, the dividend per share (if none, 0p) and payment dates. The pre-tax profits and dividends for the same period last year are given in brackets.

The rise or fall in the share price over the past year is never the full story, and some understanding of the company's strategy will help to put the new numbers in perspective. A company may have cut expenditure to increase profits now, at the expense of the long term, or conversely, it may have invested in an expensive advertising campaign, which reduces profits now, but will raise them later.

Trading volume

Trading volume can say a lot about the depth of a market move, indicating how likely it is to last. It may be defined as the number of shares traded in a stock, or alternatively as the number of shares traded multiplied by market capitalisation.

Some technical analysts see underlying volume as important, but the consensus is that it takes a secondary place to share price movements.

New share issues

Introduction

In this short chapter, we shall take a look at the markets available for companies that want to issue shares. Most of the markets we shall cover are on the London Stock Exchange (LSE). Read this together with Chapter 7, which explains how investment banks bring companies to market. PLUS Markets has set itself up as a rival to the LSE, and we look at that too.

Capital raising

A company that is looking to raise cash should consider which route is most suitable at its stage of development. If it is a young company, it may seek venture capital or borrow from a bank. A larger company may prefer to issue equities (shares) or debt.

A company may issue equities and bonds, a form of debt, on the Main Market of the LSE, which is Europe's largest exchange. The LSE and Borsa Italiana, with which the LSE has merged, hold 47 per cent of the market capitalisation of the FTSEuroFirst 100, according to the LSE's 2008 *Annual Report*.

For international companies, there is a choice between what are currently known as 'primary' or 'secondary' listings, though the FSA is considering relabelling these specific technical terms as 'premium' and 'standard' listings, which provides a better indication of the different levels of regulatory requirements. Away from the Main Market, the LSE offers companies the possibility of listing on the Professional Securities Market, the Specialist Fund Market and the Alternative Investment Market.

The Main Market

The LSE's Main Market is the world's most international market for listing and trading of public equity and of debt, including bonds. In 2008, in spite of relatively

depressed capital markets, £66.7 billion was raised in new and secondary issues on the Main Market, including 35 initial public offerings (IPOs), the majority of which were international. The investor reach is global, as non-UK-based funds buying UK equities are attracted to Main Market securities.

Companies listed on the Main Market have a market capitalisation from around £5 million up to around £200 billion, which will typically be for an international group with a multiple listing, although not all of the trading will necessarily take place on the LSE.

The Main Market on the LSE is tiered, in accordance with the UK Listing Authority's (UKLA) listing rules, which offer a primary or a secondary listing for equities and debt securities, and may be subject to relabelling. Let us look at each.

A primary listing requires a company to meet the highest standards of regulation and disclosure in Europe. It requires *superequivalence*, which means that the standards are over and above those required for admittance to EU-regulated markets. The company must have three years of audited accounts and 75 per cent of its business must be revenue-generating. All UK companies joining the Main Market are required to take a primary listing.

Companies with a primary listing must comply with the full UK Listing Rules, which means that they must comply with the Combined Code, which is the UK's corporate governance system (see Chapter 26), or explain why they do not. Primary listed companies may be eligible to be included in the FTSE UK Index series, which helps to build greater liquidity for Main Market companies by providing investors with benchmarking of stocks, sectors and the market.

A secondary share listing does not in itself mean that a company has a listing in another market. Unlike a primary listing, it does not need three years of audited accounts; the accounts must instead cover the company's life or three years, whichever is shorter. The secondary listing requirements are part of the UK Listing Rules.

A company may have a secondary listing either in shares or in global depository receipts (GDRs), which are certificates listed and traded in London that represent ownership of the company's shares on its foreign domestic exchange. GDRs are also available on the Professional Securities Market (see below).

The requirements for GDRs and secondary listed shares are broadly similar, but GDRs are often preferred by international companies because on the LSE they are traded on a dedicated order book called the International Order Book (IOB), which is not open to retail investors and which is used by professional investors interested in foreign companies. Neither secondary listed shares nor GDRs may be included in the FTSE UK index series, but they can be included in other indices. For example, the 10 leading Russian GDRs on the IOB form a distinct index, the FTSE Russia IOB.

In March 2009, the LSE launched a new Central Counterparty service for trading in the 50 most liquid depository receipts on its IOB, covering securities from Russia, Kazakhstan, South Korea and India. The service mitigates counterparty risk, increases efficiency for participants and ensures post-trade as well as pre-trade anonymity. The aim was to encourage further liquidity in these shares.

According to *Equity Markets 2009* (IFSL, 2009a), money raised from IPOs in the UK equity market fell to £7.2 billion in 2008, one-third the level of the previous year. However, secondary issues reached record levels of £63.7 billion as companies shifted to raising capital by issuing equity rather than debt. The LSE was the third top exchange for IPOs by value in 2008, with less than half the amount raised by the Bombay Stock Exchange and substantially less than the massive US\$43 billion raised by NYSE Euronext, though this was boosted by a single IPO, Visa, which raised nearly US\$18 billion. In 2008, the LSE had a 28 per cent share of international IPOs by number. The LSE has more foreign listed companies than any other exchange.

According to a paper, 'Assessing the effectiveness of enforcement and regulation' (City of London Corporation, 2009), there is some evidence that cross-listings are in decline. In Europe, capital markets appear to be giving way to a single European market. For example, the Prospectus Directive enables EU companies to raise capital from investors in other EU countries using a single prospectus.

The report (Dobbs & Goedhart, 2008) noted a finding by McKinsey & Company in *Perspectives on Corporate Finance and Strategy* (no 29, Autumn 2008), that cross-listings may no longer appear to make much sense as a strategy, perhaps because capital markets have become more liquid and integrated, and investors more global, or because the benefits from cross-listings were overstated.

The report cites academic evidence that firms cross-listing in the United States have obtained a significant valuation premium over their non-cross-listing peers in a foreign jurisdiction.

Professional Securities Market

The Professional Securities Market (PSM) is open to issuers listing debt instruments or depository receipts in London as an alternative to the Main Market. It enables issuers to follow a wholesale regime irrespective of the type of security denomination. They may use their local accounting standards rather than go through the costly procedure of preparing International Financial Reporting Standards (IFRS), as required on the Main Market.

This market was introduced to address concerns surrounding the Prospectus Directive, implemented in the United Kingdom in July 2005, and to help keep London's pre-eminent position as a listing venue for the specialist securities covered.

Many institutional investors can only buy debt instruments that are held on a Recognised Investment Exchange. The PSM accommodates a range of securities, including Eurobonds, asset-backed issues and high-yield or convertible bonds. Companies, public bodies and supranational organisations issue those bonds to raise money. The Exchange works closely with the Financial Services Authority's (FSA's) UK Listing Authority (UKLA) to offer guidance to issuers and advisers.

The Specialist Fund Market

The Specialist Fund Market (SFM) is for specialist investment managers that want to access London-based pools of capital in a flexible way, and is closed to traditional trading companies. It is designed to appeal to managers of large hedge funds, private equity funds, and certain emerging market and specialist property funds seeking admission to a public market in London.

These funds are looking for institutional investors, but not for a wider investment base. A separate market has been created for these funds because they may be unsuitable for retail investors because of characteristics such as high gearing, concentrated risks, variable liquidity and sophisticated corporate structures. These features may also make them ineligible for inclusion on the Main Market.

The SFM, which opened on 1 November 2007, had aimed to fill a specific gap identified by London's legal and investment banking community, given that in June 2007 the UKLA indicated it was abandoning its two-tier listing regime, consisting of its Main Market and a lighter 'directive minimum' regime for overseas funds (see Chapter 19, under *Split-capital investment companies*). The lighter regime had attracted claims of inadequate investor protection from some investment trusts and traditional fund managers.

Investment funds may list on the Main Market under Chapter 15 of the Listing Rules. From March 2008, the FSA relaxed this regime to make it more attractive for overseas funds to list. With these changes, and the introduction of the Specialist Fund Market, London is catching up with NYSE Euronext Amsterdam, which has led the way in attracting alternative investment vehicles. The LSE has attracted listings from companies including Boussard and Gavaudan Holdings and NB Private Equity Partners, which are listed on Euronext Amsterdam.

The Alternative Investment Market

The Alternative Investment Market (AIM) was created by the LSE in 1995 to meet the needs of small growing companies, and is a high-risk/high-reward market. Typically, companies on the AIM will have a market capitalisation of

anywhere from £2 million upwards; the largest may be up to £500 million, although they would almost certainly not be that size on joining the market.

Admission requirements are less rigorous than for a full LSE listing, although in such areas as disclosure of price-sensitive information, the requirements are not that different from those of the Main Market. A start-up company can go to the AIM without three years of IFRS accounts, but if it has a track record, it must show the accounts. If an AIM company wants to make a straightforward takeover, it need not first obtain shareholder approval, though shareholder consent must be sought for reverse takeovers or divestments, which result in a fundamental change of business.

The LSE has been promoting the AIM as a secondary stock market listing in London for non-UK companies that wish to retain their local market main listing. It has focused on, among others, the Benelux region, China, Australia, India, Russia and Kazakhstan.

As at the end of August 2009, 1,365 companies were quoted on the AIM, including 264 non-UK companies, with a total market capitalisation of £51.7 billion. By that date, companies quoted on the AIM had raised £62.9 billion, of which £30.2 billion was raised through secondary equity issues after admission to the AIM. So far, 86 AIM companies have moved to the Main Market, for which the AIM can serve as a springboard.

The regulatory framework of AIM hinges on the Nominated adviser, or Nomad, which brings the company to the market and is responsible for its behaviour afterwards. A company has a direct line to its Nomad, which is in turn regulated by the LSE.

On 20 February 2007, the LSE announced some regulatory changes for the AIM. A separate rule book was introduced for Nomads, which codified best practice. The Nomads had greater responsibility than before for assessing a company's suitability, its business plan and management, and it became easier for the LSE to discipline the companies. For natural resources companies, a competent person's report had to be carried out. AIM companies became subject to enhanced disclosure requirements, which included a requirement, from August 2008, to display core management and financial documents on websites. In late 2008, the LSE launched AIM Italia, a new growth market, with a structure based on the AIM model. In June 2009 TOKYO AIM, a joint venture partnership between the Tokyo Stock Exchange and the LSE, opened for business.

The AIM still is accused of light-touch regulation. In June 2009, the LSE publicly censured and fined Astaire Securities, previously known as Blue Oar, for failure in its role as Nominated adviser. Astaire had failed to assess the appropriateness of a company it advised for an AIM listing and had breached the rules between 2006 and 2007.

This was the second fine and public censuring of a Nomad since the Exchange introduced the Nomad rules. The LSE does not necessarily make public all its disciplinary actions. How it proceeds depends on what the disciplinary committee deems appropriate.

The AIM is currently positioning itself as a global market, using a revamped and user-friendly section of the LSE's website.

PLUS Markets Group

PLUS Markets Group is a relatively new stock exchange in London, commencing operations in 2005, and focusing on growth companies. It operates two markets – PLUS-listed and PLUS-quoted. The first, which in regulatory terms is analogous to the LSE's Main Market, is for companies admitted to the UKLA's Official List; the second is for unlisted, or 'quoted' growth companies, and is the regulatory equivalent of the LSE's AIM market.

PLUS has been a recognised investment exchange (RIE) since July 2007 (see also Chapter 16), and this change in status allowed it to launch the PLUS-listed market for companies applying for admission, or already admitted, to the UK's Official List. The RIE status also enhanced the group's cross-border listing status and reputation, and broadened the range of institutions able to invest in PLUS companies.

The group's market for quoted companies, the larger and more established of its markets, specialises in small to mid-cap businesses. The admission process is designed to help smaller companies access a public market, with the process and associated costs proportionate to the size of the company and fundraising requirements. Ongoing regulations for these smaller companies are also designed to be clear and simple, recognising the need to avoid any unnecessary compliance burden, whilst at the same time offering protection to investors.

PLUS-quoted companies are, like AIM companies, considered 'unquoted' for tax purposes. This means that investors in PLUS-quoted companies may benefit from a range of tax reliefs, subject to the normal qualifying criteria. This includes capital gains tax and inheritance tax reliefs, eligibility for venture capital trusts and enterprise investment schemes, and eligibility for inclusion in self-invested pension plans (SIPPs). Investments in the PLUS-listed market will be eligible for ISA investment.

According to a review of the PLUS markets by an independent accounting firm and PLUS corporate adviser Vantis, PLUS saw 42 companies join the market in 2008, with fundraising slightly ahead of that achieved in 2007. In 2008, PLUS-quoted companies raised £67.8 million, up £1.5 million on the previous year, of which £53.6 million was secondary fundraising, taking the total level of secondary fundraising in 2007 and 2008 to over £100 million.

Investment banking

Introduction

Firms active in investment banking raise money for clients in the capital markets, and they advise on mergers and acquisitions. Investment banking is also known as corporate finance, and this chapter explains how it works. Read it in conjunction with Chapter 6, which covers new issues.

Overview

In the lucrative area of investment banking, the procedures for getting together a syndicate of banks, running a book and underwriting are broadly similar for issuing equities, on which this chapter is mainly focused, and for debt. Banks are increasingly merging their equities and bonds origination activities. Investment banking also includes mergers and acquisitions advice, covered at the end of this chapter. Elsewhere within the bank, traders deal with other banks directly or through money brokers, trading securities for themselves, as proprietary traders, and for investors. The salespeople manage investor accounts.

Credit crunch

The credit crisis triggered in late 2008 the demise of the standalone investment bank as a business model, with the collapse of Lehman Brothers and the takeover of Merrill Lynch. Goldman Sachs and Morgan Stanley, the last of the bulge-bracket investment banks, converted to bank holding companies. They became universal banks in the same space as Citigroup, Deutsche Bank and Barclays, which offer investment banking as part of their activities. Both banks had announced plans to expand their own modest retail deposit-taking businesses and, by way of expansion in this direction, would be able to buy commercial banks.

In practice, there was a feeling that these banks would carry on their investment banking activities seriously. In early December 2008, Professor Alan Taylor from the Department of Economics, University of California Davis Institute of Governmental Affairs, said on local television that Goldman Sachs and Morgan Stanley had gone through the process of conversion to get under the US federal authorities' umbrella of protection.

Such protection comes at a price. The two banks, in converting to holding companies, submitted to tougher regulation and supervision, but from several government agencies rather than, as before, only the Securities & Exchange Commission. As part of this conversion, they now disclose more than before. They also need more capital relative to borrowings, which reduces risk, but also potential returns on equity.

Initial public offering

If a company is going to issue its shares on the Main Market, it may launch an initial public offering (IPO). There are some variations in definition. Ernst & Young defined an IPO in its *Global IPO Trends 2007* as 'a company's first offering of equity to the public'. London Stock Exchange (LSE) statistics refer to a company's first offer of shares on its market as an IPO, even when the company has issued shares on another market. An IPO is used particularly by large issuers. Let us see how it works.

Beauty parade

The IPO starts with the *beauty parade*. One bank, or two jointly, as selected by the issuer, will land the lucrative job of book runner, which is running the book of orders for the deal.

In choosing between candidate banks, the issuer looks for a track record in floating similar companies. There are other criteria. Mike Lynch, chairman of the software company Autonomy, told me it has appointed banks as book runners in capital-raising initiatives primarily on the basis of how well they understood the business, but also based on the bank's geographical distribution power.

An obstacle to becoming a book runner is any unresolved conflict of interest: for example, if the bank is launching the IPO of a rival company. On a similar basis, if two banks are to be selected as joint book runners, any historic conflicts will come under scrutiny. In practice, many IPOs and secondary placements are handled by banks that have a corporate relationship with the issuing company.

Once appointed, the book runner takes lead responsibility for placing the newly floated shares with investors, and in a sizeable deal, it will organise

backup from a syndicate of other banks. The bank at the top of the syndicate may have the status of global coordinator, and other banks within the syndicate may have key roles such as lead manager or manager.

A method of selecting the book runner for an IPO, known as competitive IPOs, has arisen by which banks compete for a mandate on the basis of how easily they can gain indicative support from investors for the proposed flotation. There has been some regulatory concern that analysts may be under pressure to provide positive research about the issuer as an investment opportunity, thus compromising their independence in an undeclared way.

Pre-marketing

In a pre-marketing phase, the book runner meets with potential investors and presents the investment case for the company it is bringing to market. It provides an indicative share price for the IPO and sets parameters for the subsequent pricing of the new issue, often making these public. Analysts away from the deal may say that the range is too high or too low against company fundamentals or peer ratings, and based on their comments, the press may take a view.

The book runner may occasionally move the indicative price range up or down. If so, it means that it had not properly anticipated demand, perhaps because of changing market conditions. If the price range shift is downwards, concerns may arise that the book runner may ultimately postpone the offering. This has sometimes happened.

The book build

The book build is based on investor interest that the banks have drummed up during the pre-marketing phase. The banks build an order book through a road show, which, in the case of large issues, travels across continental Europe and the United States as well as the United Kingdom. Banks in the syndicate organise group presentations, and outside the visiting schedule, may use video conferencing. The company's chief executive, finance director and head of investor communications address potential investors alongside the book runner's corporate financiers and analysts. One-to-one presentations will be organised by the banks with *tier one* clients, which are the biggest and most important.

A traditional book build lasts two to three weeks, but it can take longer under difficult market conditions. The pressure is then on investors to subscribe to the IPO. Most orders are confirmed two days or less before the book closes.

Once the IPO date has been declared, the entire process becomes highly susceptible to market news and conditions. The financial spread-betting firms may run a bet on the future price of a popular pending new issue. They will have

set an unscientifically derived *grey market* price that may be quoted in the press and sway investors. This can become a self-fulfilling prophecy, although usually only a few punters will have placed bets.

Underwriting

When a company is brought to the market, it is typically underwritten. The underwriter is an investment bank that guarantees a given price for a given number of securities to the issuer in exchange for a fee. The riskier the deal, the larger is the underwriter's fee.

Underwriting fees on US transactions average between 6.5 and 7 per cent of the amount raised, compared with between 3 and 4 per cent on European exchanges, according to *The Cost of Capital: An international comparison* (Bell, Correia da Silva and Preimanis, 2006).

Pricing

The issuer and book runner set the issue price ideally at the maximum level acceptable to institutional investors. If the deal is oversubscribed, the price may have been too low, but some oversubscription is likely in a successful IPO because, to ensure adequate share allocation, investors tend to request more shares than they want. This in itself helps to create demand, including in early secondary-market trading.

When pressed, major investment banks have admitted that the criterion for pricing the deal is not value but demand, which can partly be created. It is influenced not just by market conditions, but also by perceptions of interest that the issuer, book runner and PR initiatives have been able to whip up.

With retail investors involved, a book runner may price a new issue higher. This is partly due to the extra take-up and the publicity it generates, but also because the price will usually then be more sustainable in early secondary-market trading, helping to safeguard the reputation of the book runner, which is particularly useful if it had overpriced the issue in the first place. Retail investors often hold new issues long after they ought to have sold, partly because they are inadequately informed.

In the business pages of *The Times*, you will find a table headed 'Recent issues'. It includes stocks recently issued on the stock market, including the AIM, with yesterday's closing price, and any rise or fall on the day.

Early secondary-market trading

In good market conditions, a deal will typically reach a small premium, perhaps 10–15 per cent, over the issue price in early secondary-market trading. This

creates demand for the shares, fuelled further by any oversubscription for the issue. If the free float is small, meaning that the shares are tightly held by company directors and few are available to the public, demand may quickly exceed supply and the share price may soar.

Institutional investors who bought shares during the IPO process may snatch a profit by selling the shares early in the first days or weeks of secondary-market trading. Such ‘flipping’ is often the best way to make money quickly from new issues, contrary to the buy-and-hold strategy often recommended to retail investors.

The book runner may welcome some flipping from favoured institutional investors because it needs liquidity to establish value in the shares and to meet the demands of buyers. After a few weeks the shares are likely to lose their initial momentum and, at least for a period, to slip below the offer price.

In poor market conditions, new issues are infrequent. If they happen, the shares may start trading at a discount to the issue price.

Specialist types of share issues

Accelerated book build

In an accelerated book build, the bank takes a selling company’s shares in a listed company onto its books, and offers them to its investor clients. It will sell the shares in the course of one day or, exceptionally, over two or three days. This compares with several weeks for a conventional book build and allows less time for market conditions to deteriorate. In a declining market, institutional investors respond favourably to this form of capital raising, which may be used to raise up to 5 per cent of share capital in one year.

Bought deal

The bought deal is where a bank buys securities itself from an issuer and resells them in the market. The bank will have assumed all the risk by itself and so must have confidence in the deal. Issuers are often attracted to a bought deal because it gives instant liquidity.

Rights issues

If a UK company wants to raise more than 5 per cent of its existing market capitalisation, it must use a rights issue. The company will issue new shares to existing shareholders pro rata to their existing holdings. In a ‘1 for 5’ rights issue, for example, shareholders will have the right to buy one further new share

for every five they hold. The process takes perhaps six to eight weeks, twice the length of a conventional share offering.

Through a rights issue, shareholders have an opportunity to acquire new shares without paying their stockbroker a commission. They do not have to buy, and if they are to do so, must be convinced that the company will use the cash properly. If the rights issue is to pay off debt, shareholders should assess the chances of success before they subscribe.

The issuing company will usually appoint an underwriter, generally a major bank, to the deal, which guarantees full subscription (see above under 'Underwriting'). If the issue fails, the underwriter will take up the rights. Some rights issues are not fully underwritten, which can be a high-risk strategy for both the issuer and the underwriter.

Once the rights issue is underway, the share price can fluctuate, which may happen more in uncertain markets or if the issue is for a purpose that may not benefit shareholders, or if it is not fully underwritten. Hedge funds may trade the underlying shares, which can cause havoc with the price.

The new shares in a rights issue will be priced lower than the market value of the existing shares. In difficult markets, the discount might be as high as 40–50 per cent, which is known as a deeply discounted rights issue and is more likely to attract subscription.

Following a rights issue, the overall share price will find a balance pro rata to the price of the old shares and of the cheaper new shares, in proportion to the number of shares in issue of each. The share price is often slightly lower than before the rights offering. For capital gains tax assessment, HM Revenue & Customs considers the new shares were acquired at the same time as the original ones.

Shareholders not interested in a rights issue may sell the rights to which they have not subscribed, known as nil paid rights, to other investors. After they have received the proceeds, and the share price has adjusted down as a result of the rights issue, they will be in a cash neutral position.

Unsubscribed rights are known as the rump. The book runner will later sell them to new investors in an accelerated book build (see above).

The Rights Review Group was established by the UK chancellor, Alistair Darling, in summer 2008 to review the rights issuance process. Acting on the Group's recommendations, the Association of British Insurers (ABI) in early 2009 changed its guidelines, which are not legally binding, but are considered best practice, to increase the limit on the amount that may be raised in rights issues without obtaining approval at an annual general meeting from one-third to two-thirds of share capital. The Financial Services Authority (FSA) reduced the minimum subscription period for companies that undertake a rights issue from 21 calendar days to 10 business days. As a result of the changes, the period

of a rights issue was reduced from 39 to 16 days. The new abbreviated timetable was, however, voluntary.

Many felt that a reduction in the rights issue period would be helpful in reducing the risks of rumours and related short selling, although this was not the reason for it. The regulator claimed there had been market abuse during a March 2008 capital raising by HBOS. The take-up on HBOS had only been 8.3 per cent of shares offered. The FSA alleged that short sellers had spread rumours about the stock, hoping that the share price would fall and they would buy shares back later at a lower price, but its investigation came to nothing.

The rights issue structure is under review. The Rights Issue Review Group has examined the Australian RAPIDS (Renounceable Accelerated Pro-rata Issue with Dual-book-build Structure) approach. This is a two-tranche shareholder offer, to institutions within one business day, and then to retail investors. However, there are differences between the UK and Australian markets. RAPIDS is preceded by a trading halt to allow time to ascertain who owns the shares and to decide to whom to make the offer. In the United Kingdom, there is a reluctance to halt trading in this way, and besides, the complexity of nominee holdings makes it difficult to find out whether the shares are owned by retail or institutional investors.

Placing

In a placing, the broker issues a company's shares privately to institutions, at least some of which are its own clients. This form of capital raising is often used to raise small amounts, and may be enacted through a broker or investment boutique rather than an investment bank. A company is permitted to raise up to 5 per cent of share capital in one year through a placing. Retail investors are not usually given the opportunity to buy.

Placing and open offer

A placing (see above) may be done simultaneously with an open offer to existing shareholders. This dual approach is used to place shares in already quoted companies. The shares are placed provisionally with institutions, but subject to clawback by shareholders, should they exercise their right to take up shares under the open offer. Sometimes key shareholders will have undertaken to take up some shares.

A placing and open offer can be a quicker and more reliable way to raise cash than a rights issue, particularly in difficult markets. The amount raised must be below the size threshold at which a rights issue becomes compulsory (see above), and so this approach tends to be for small capital raisings, typically under £50 million.

Introduction

An introduction is where the company joins the LSE's Main Market without raising capital. The process requires no underwriting fees and little advertising. It is sometimes used as a preliminary move in anticipation of future capital raising activities.

Bond issues

When interest rates are low, listed companies may find it cheaper to raise money through corporate bonds (see Chapter 12) than through equities. For example, if a company issues bonds, it may have to pay a coupon of 6 per cent, but if it issues equities it may have to give shareholders a 10 per cent return. This example is hypothetical because the ratio can vary significantly according to market conditions.

In the United Kingdom and some other developed economies, interest payments made by issuers on bonds are tax deductible against the issuing company's profits. Let us assume that the bonds pay a 6 per cent coupon. Based on a 30 per cent corporation tax (the rate can vary a bit from one year to the next), the true cost of servicing the bonds would be $6 \text{ per cent} \times 0.7 = 4.2 \text{ per cent}$.

Companies sometimes issue bonds and use the cash raised to buy back shares from investors. The downside of bond issuance is the risk of taking on too much debt in relation to equity, which is known as 'high gearing' and gives the issuer a riskier profile with the credit-rating agencies. Generally, banks have easier access to debt capital than companies and are more highly geared. Debt issuance is likely to be the second largest liability on a major bank's balance sheet, behind cash deposits.

The bond issuer cannot skip paying the coupon, as is possible with dividends on shares. It also must repay the principal on maturity, but can refinance by issuing new bonds.

Banks, like companies, invest cash in bonds, across the risk spectrum and in all major market currencies. Some bonds will be included on the asset side of the balance sheet where, in terms of risk weighting under Basel II (see Chapter 3), they are more attractive than loans.

Issuers of bonds usually offer a fixed rate of return, which is what investors prefer. But if the bonds fall in value, investors may feel they have lost out. This is why investors use the swaps market, which enables them to swap fixed for floating rates. The majority of the swaps market consists of interest rate swaps (see Chapters 8 and 11).

Mergers and acquisitions

Mergers and acquisitions (M&A) is the area where investment banks are often compared and judged. They will advise a company that is either a likely bid target or planning a takeover, and may help it to raise capital for the purpose.

The prospective buyer of a quoted company can be another UK company, from Europe, the United States or elsewhere. Alternatively, it can be one of the private equity firms; these are able to acquire a listed company and take it private. Private equity has more resources to make acquisitions than quoted companies, and is not similarly encumbered with the need to make merger synergies.

To finance an acquisition, a company may use the capital markets. The acquirer pays for a target company's shares with cash, its own shares or both combined. When appointing a bank with investment banking activities as an M&A adviser, the company will make the choice itself, probably selecting the candidate with the best ideas. For smaller transactions particularly, there is a growing trend for companies to use in-house M&A advisers, perhaps ex-bankers.

An investment bank's fee for M&A advice is up to 2 per cent of the deal's value, diminishing as the deal becomes bigger. The bank is only paid if the bid proceeds, and its risk is that the bidder may withdraw, perhaps after it has concluded a due-diligence inspection or a rival bidder has muscled in. If a bank is advising a company making an acquisition, it may also raise capital for it, which is more lucrative.

Should the bank be acting for a target company, it may fend off the bidder with the intervention of a *white knight*, a congenial rival bidder, or may block the deal with a *white squire*, a significant minority shareholder. As a twist on the theme, the bid target may make a counter-bid for the bidder.

If a takeover is to go ahead, the predator must obtain more than 50 per cent of the target company's voting shares. Once its stake has reached 30 per cent, it must make a formal offer to all shareholders. If some shareholders decline to take up the offer, a buyer can acquire their shares compulsorily once holders of 90 per cent of the voting shares have accepted.

The Panel on Takeovers and Mergers, an independent body with statutory powers, supervises and regulates takeovers with the aim of ensuring fair treatment for all shareholders.

According to the International Financial Services London Equity Markets June 2009 report, M&A activity in Europe, based on the target company's location, declined 27 per cent in 2008 to US\$1.2 trillion (Maslakovik, 2009e).

The future

The credit crunch, starting in 2007, and subsequent events, particularly the collapse of Lehman Brothers, nearly destroyed the banking system. By 2009, there were signs that lucrative investment banking activity had returned, partly due to the financing demands of desperate companies. Advisory and underwriting work, and trading in less volatile markets and emerging markets, were in some cases doing well.

New recruits were back in demand. According to a survey by recruitment specialist Robert Walters, the investment banking job market stabilised in the third quarter of 2009 as confidence returned, although it was not at the peak level seen in 2007. Candidates for jobs were once again receiving counter-offers and there was a skills shortage.

Outside the large banks, former investment bankers had started setting up investment banking boutiques, particularly in Mayfair, or changing the models of the existing ones. The idea was to pick up some of the service business from which the large banks had withdrawn. How long these small operations will last remains to be seen.

Bank bonuses have come under global scrutiny, which may have an impact on future earning both in and around the City. British banks have agreed with the FSA that it will look at bonus packages. Banks will liaise with their regulator, making sure that remuneration is performance related and that there is a long-term focus, including such features as clawback or paying out remuneration over an extended period. There are concerns, however, that other countries, which have agreed to a similar approach to bonuses, will not implement the same rules at the same time. If not, the United Kingdom could lose banking staff to countries that do not apply the same rules and so can pay them better. This could threaten London's competitive status, which seems disproportionate given that bonuses were not, in themselves, responsible for the credit crisis.

As ever, investment banking remains a source of fascination to the public, but the vision of it fluctuates with the times. In July 2009, a BBC2 drama, *Freefall*, illustrated the impact of the credit crunch. In one strand of the play, a star banker trades mortgage-backed securities, and in another, a family buys a mortgage it cannot afford from an unscrupulous mortgage broker. Securitised mortgage trading in investment banks had fuelled the mortgage boom, and so the strands are linked. The drama depicts the banker as the villain and the family as the victim, but both parties are likable. One message is that investment banking and the mortgage-lending bust took a human toll on bankers as well as on homebuyers.

Introduction to derivatives

Introduction

In this chapter, we shall define derivatives and see how they work. We shall examine the distinctions between on-exchange and over-the-counter derivatives markets, and the various products, as well as clearing and settlement. We focus on the uses of derivatives for hedging and speculation.

Cash and derivatives

In the cash market, trades are in an underlying investment: for example, Microsoft stock, British Airways bonds or 100,000 barrels of oil. Cash is paid for assets and delivery is made. In derivatives, there is a financial or paper transaction, not on the underlying asset, but based on its value, and that can turn into a deliverable. The demand for derivatives has grown far more than for cash products, according to market sources.

Derivatives include four basic transactions: spot, forward, option and swap. More complex terminology may be used, depending on which of the asset classes are involved.

The asset classes are credit fixed income, financials, interest rate market, equity and commodities. Credit fixed income includes credit derivatives, bonds, commercial paper and loans; financials cover foreign exchange and forwards; interest rate markets include interest rate swaps and options, and deposits, as well as forward rate agreements and overnight index swaps.

Of the rest, equity is about the stock market; commodities cover soft commodities such as food, feedstuffs and beverages, including grains, pork

bellies, shrimp, wines, wheat and corn, as well as hard commodities, which are industrial raw materials such as oil, gas, electricity, nuclear fuel and metals. For more on commodities, see Chapter 13.

Within all these asset classes, you will find two types of trading: on-exchange, which takes place on an exchange, and over-the-counter (OTC) which is a customised transaction off-exchange. We shall look at the distinction in more detail later in this chapter.

Both on- and off-exchange trades in the money markets (see Chapter 11) may be in either the underlying instrument such as shares or bonds, or its derivatives, which are based on the underlying instrument.

Let us now take a look at the four main types of derivative transactions, any of which may be used for either taking a position or hedging.

Four types of derivative transactions

Spot

When a derivative is spot, the price at which you trade is known to you now, and you buy and take delivery. The transaction timescale is typically short. It is expressed as $T + 1$ or $T + 2$, which is the trade date plus the number of business days until settlement. For example, trades in foreign exchange (covered in Chapter 14) are $T + 1$: you trade today, and transfer the money and receive your purchase the next business day.

Forward

On a forward derivative transaction, the price at which you will trade is set in the future. If you trade a forward on an exchange, it is called a future. If you trade a forward on the OTC market, it is called a forward.

For futures, there could, for example, be a March delivery that stipulates delivery of 1,000 lots of an underlying commodity on 23 March. As a trader, you will either reverse out of the future before that date, or there will be delivery of the underlying instrument. On the forward market, you will choose the day of delivery.

A brief case study best shows the distinction between forwards and futures. Let us assume that you will need to exchange US\$1 billion on 23 March because, on 24 March, you are required to pay for a factory. If you buy a future on an exchange and delivery is on 23 March, this fits exactly with your requirement. But if the exchange contract expires on 15 March, you will receive the money earlier than you need, or if it expires on 15 April, you will receive it later. Either would be an imperfect hedge.

On the OTC market, you can avoid this because the contracts can be tailor-made. You may buy a three-month forward on 23 December and receive payment on 23 March. If, alternatively, you ask the bank on 6 January for a forward to 23 March, you can get it, although this is a broken date because it is not over a standard period, and it will cost more because of both the decreased liquidity and the need to find a willing counterparty.

Option

An option is a right, but not an obligation, which distinguishes it from a forward or a swap (see below). If you have an option to buy euros at £1.50 in three months, and the price rallies to £1.55, you will be pleased to exercise at £1.50 and make 5p profit, less expenses per option held.

The risk with OTC trades is that if the entity that wrote the option is no longer viable, you cannot exercise it, and no clearing house will take on the responsibility of completing the transaction. This means you need to look at credit risk carefully. The collapse of Lehman Brothers in September 2008 and other events in the financial crisis have raised awareness of such risks.

For OTC options and similar, banks have a team of specialists assessing the creditworthiness of counterparties and clients. For a detailed explanation of how options work, see Chapter 9.

Swap

To see how swaps work, let us imagine that company A and company B each need a loan of £100 million. Company A can only get a variable (that is, floating) rate loan from its bank, but it wants a fixed rate to avoid exposure to a rate rise, which it believes will happen. Company B, conversely, can only get a fixed-rate loan of 4 per cent, but it wants a variable rate to avoid exposure to a rate decline, which it believes will happen. If rates should fall, the loan interest would become cheaper, enabling the company to retain a higher proportion of its profits.

An interest rate swap gives each company the chance to achieve strategically what it wants. Company A will swap its variable-rate loan with the fixed-rate loan of company B. Even after paying charges, both company A and company B benefit.

From a company perspective, swaps can save money. If a mid-sized company embarks on a 10-year investment project in Japan, let us assume it needs to borrow yen, the local currency, at a fixed rate to cover the cost of the project. Let us say that nobody in Japan has heard of it, and so it is offered a 10-year loan at a high fixed rate or at a lower floating rate. It could take a floating-rate loan and instruct its bank to arrange a 10-year swap, which gives it

fixed-interest cash flows. The overall cost will be lower than for a 10-year fixed-rate loan.

Sometimes, companies can negotiate 10-year fixed-rate loans at a very low fixed rate, but actually require floating-rate money to meet short-term commitments. A company may borrow the money by issuing a low fixed-rate 10-year bond (see Chapter 12) and swap it for a floating rate.

Banks trade swaps with each other, typically acting for clients, which are increasingly hedge funds. In about 50 per cent of cases, the banks will use a broker. In the past, it was easy to cancel the contract if conditions were not met, which caused problems. The International Swap Dealers Association has since introduced full two-way agreements by which, if there is a default, swap counterparties will net swap agreements.

The swaps market has developed from nothing in 1982 to a level that dwarfs the bonds and equities markets together.

Hedging and speculation

Warren Buffett, widely considered among the world's most successful investors, once famously described derivatives as *weapons of mass destruction*. Derivatives specialists in the City see this as only one side of the story.

Companies use derivatives as a cheap and effective way to hedge their positions. The economic rationale behind the earliest futures was to hedge against price risk. Hedging has the effect of insurance, and is at the other end of the pole from speculation, for which the very same types of derivative may be used. If a company takes a 4 per cent variable loan, it can hedge itself against the risk that the rate could soar to a much higher level. If it does not, it will be vulnerable to the full hit.

Some of the big corporate scandals in 2005, including Enron, WorldCom, Ahold and Parmalat, made no ripples in the market because the financial risk was hedged with derivatives, according to City brokers. When a company invests in derivatives, it is across a range of them, which reduces the risk of systemic failure.

Then there are the speculators, who have always taken second place, but they are the key liquidity providers. They make hedging possible and sometimes advisable.

On-exchange versus OTC derivatives

An exchange-traded contract has the advantage of being standardised, which makes it much cheaper and means that you can move a large deal quickly, with very little price impact. There is no counterparty risk because you are dealing

with the exchange. An OTC contract, unlike its exchange-traded counterpart, is negotiated between both parties to the contract. It is more flexible than the contract traded on exchange, but is less transparent and harder to value.

The main use of exchange-traded derivatives for professionals is for hedging, according to market sources. For example, a bank that buys a government bond may automatically hedge it in the futures market. Products tend to start on the OTC market, and it is only after several years of established maturity that they are mimicked in the on-exchange markets, where a lot of liquidity in one place is needed.

According to data provided by NYSE Liffe and the London Stock Exchange (LSE), the value of daily turnover in exchange-traded derivatives in London is around 200 times the size of exchange-traded equities, amounting to £1,800 billion a day compared with £9 billion on the LSE. On-exchange trading in financial derivatives in London is focused substantially on two main exchanges.

One is NYSE Liffe, the third largest derivatives exchange in the world, and the largest in Europe by value of business traded daily. Liffe's business had been very London-centric as a floor-based market, but in 2000 it moved to electronic trading. This, coupled with the merger with Euronext in 2002 and with NYSE in 2007, has increased its customer base and scope, significantly internationalising the business. NYSE Liffe now has customers in over 30 countries around the world, but 70 per cent of its business comes from Europe, most of which is from the United Kingdom.

The other main exchange is Eurex, a Frankfurt-based exchange owned jointly by SIX Swiss Exchange and Deutsche Börse, on which over half of all trading is derived from London.

OTC derivatives, in contrast to exchange-traded derivatives, are a market only for professional investors, and some market estimates have suggested this is about four times the size of the market for exchange-traded derivatives, although this figure has fluctuated in volatile markets. Banks prefer to use the OTC market because they do not compete with the person in the street, and when trading on their own book, will use it more often than exchanges.

Trades in OTC derivatives are made on the phone, often via inter-dealer brokers, and electronic services are not yet used extensively. The process of confirming trades can be laborious, and there have been moves to automate the process. Also, there are regulatory concerns about the backlog of unconfirmed trades.

Given that many of the contracts are bespoke, there may be similar deals at different prices, depending on the margin put up as collateral or the counterparty's creditworthiness. The best execution requirements of the Markets in Financial Instruments Directive (see Chapters 16 and 23) are not always applicable to OTC markets, where bonds as well as derivatives are traded. The client of an OTC trade

may trade on an agency basis, with best execution, or ask for a quote and decide whether to enter a transaction with his dealer without best execution.

According to an April 2007 survey (McKenzie, 2007) international OTC trading was heavily concentrated in the United Kingdom, which had a 43 per cent share, and the United States, which had 24 per cent. The UK share has risen from 36 per cent in 2001, while the US share has grown from 18 per cent. Within the United Kingdom, the OTC derivatives market became even more concentrated than before. Between 2004 and 2007, the share of the top 10 financial institutions rose from 79 per cent to 81 per cent. In 1995, the share of the top 10 had been 52 per cent.

Interest rate derivatives (see Chapter 11) and credit derivatives (see Chapter 12) are the largest categories of OTC derivatives, but there are many others.

Modelling and the human factor

The problem with derivatives is not the product itself, but how it is sold or managed. If a company is to trade in derivatives, it must understand their value. Software data will calculate the *value at risk* (VaR), which shows how much the company is willing to lose at any time. The VaR changes daily. Banks have thousands of loans on their books, both receiving and giving. They need good systems and procedures to determine VaR, and this is an underlying complexity. In the credit crisis starting in 2007, it is agreed that VaR failed to forecast the likelihood and size of the most extreme risk. The most important element is arguably the collective behaviour of institutions, and this is excluded from VaR.

At the same time, models incorporating VaR are helpful if the limitations are accepted. Traders and salespeople must behave responsibly. An over-zealous derivatives salesperson could go to an unaware company treasurer and say, 'Swap your fixed-rate for a variable-rate loan. Nothing will happen to rates.' If rates then go from 4 to 12 per cent, the company would have problems.

There can also be related fraud, as when trader Nick Leeson brought down Barings Bank in 1995, using deceit to cover for his derivatives losses, but it is infinitesimal compared with the amount of derivatives trading. For more on the Barings collapse, see Chapter 2.

The gap between exchange-traded and OTC derivatives trading is closing. Some classes of standardised OTC derivatives contracts have been brought into centralised clearing.

Clearing and settlement

There are two main ways to clear and settle derivatives: central counterparty clearing (for practical purposes synonymous with using a clearing house) and bilateral settlement.

On-exchange futures and options trades, and some OTC trades, are cleared through a clearing house acting as central counterparty, which takes on the risks associated with the trade. The central counterparty eliminates not only the credit risk, but the delivery risk as well. A clearing house can only clear trades entered into by, or given up to, its clearing members, which means that a broker, if not itself a clearing member, would have to give up the trades to a clearing member to enable the delivery of central counterparty clearing services.

Clearing members, generally banks, must place collateral, or margin, with the central counterparty, in each case perhaps tens of millions of pounds, which is used to manage their positions in the event of a default. They must contribute to a default fund, which, if the margin should prove insufficient, may be used in the event of a default of a clearing member. They are not able to use the money, but receive some interest on it.

Eurex Clearing clears and settles derivatives business on Eurex. LCH.Clearnet, Europe's largest independent clearer, undertakes this role on the London Metal Exchange (LME), and the recently created NYSE Liffe Clearing outsources some of its activity, including default management to LCH.Clearnet (see Chapter 13). Metal forward contracts on the LME are settled by exchanging warrants, which are records of physical metal ownership in LME-approved warehouses.

In some OTC markets there is no central counterparty, so a trader must assess its counterparty's credit and delivery risks. If the traders are satisfied, the deal is bilaterally settled; if not, the deal does not get done.

If an acceptable OTC counterparty is found and the trade is bilaterally settled, the buyer and seller are anonymous until the broker has put them together. The deal is the responsibility of the two counterparties, and the broker simply matches them. Bilateral settlement has been used for interest rate and credit derivatives, currency options and most spot and forward transactions. It typically involves payment over the period of the contract, and a possible transfer of collateral.

LCH.Clearnet clears a lot of OTC as well as standardised derivatives, guaranteeing the trade, with its largest OTC market being the interest rate swap market, where it clears 64 per cent of interbank volume, on December 2008 figures. By November 2009, the notional amount of cleared trades outstanding in SwapClear, LCH.Clearnet's interest rate swap clearing service, was US\$206 trillion. In some OTC markets, however, the potential loss is so great, and movements are so

volatile, that no entity has been willing to be the central counterparty. LCH.Clearnet is in discussions with banks about a clearing solution in the foreign exchange futures and options market.

For those who want to do business away from the central market, meaning OTC, but also want central clearing and processing, NYSE Liffe offers its Bclear platform, where demand in 2009 rose 36 per cent from January to October. Deals, once agreed, can be submitted to Bclear for processing and clearing, with NYSE Liffe Clearing as central counterparty to all transactions between clearing members, so significantly reducing the counterparty risk involved in bilateral OTC deals.

Bclear was a pioneer in this combined area but is no longer unique. LCH.Clearnet clears a broad range of OTC products, including interest rate swaps through SwapClear, repos through RepoClear and specialist products such as freight, iron ore swaps and fertilizer swaps, and it is looking to extend its clearing services into other asset classes.

The credit crisis

The derivatives exchanges are presenting their commercial case more easily after the crisis. The financial crisis showed that parts of the OTC market involving some bilateral contracts did not really work, with liabilities both poorly understood and ultimately destabilising. The problems in the inter-bank lending market that followed arose because banks would not lend to other banks while they suspected them of sitting on enormous OTC losses. In contrast, derivatives and clearing houses have performed robustly throughout.

According to LCH.Clearnet, a main security concern is not whether the contract is traded on exchange or OTC, but rather whether a central clearing counterparty has been used, because this guarantees the trade. Indisputably, the crisis has highlighted the value of the clearing house, which guarantees trades that are cleared through it. The clearing house makes an independent calculation of each of its members' market positions and calls a margin deposit on that basis, at least daily; for some asset classes, it can be intraday. Members in trouble will have difficulties in paying the margin payment, and can, at this point, be put into default; the clearing house then assumes their positions which, if they belong to clients, can be transferred and, if they are proprietary, will be sold on or closed out. Not all OTC trades are cleared, and unwinding these in the event of a counterparty default can be a long and complex process. In addition, some structures are so complex and illiquid that they are difficult to price, particularly at a time of market stress.

The clearing house has default funds to which members contribute. The greater the default, the deeper into these funds the clearing house may have to dig. In the aftermath of the Lehman Brothers collapse in September 2008, LCH.Clearnet did not need to dip into these funds to cover defaults on either the standardised, exchange-traded contracts or OTC interest rate positions; the clearer's nightly mark to market on these contracts meant that it could simply use the margin payments Lehman had posted with the clearing house to manage the default. When Lehman went under, it took only three weeks for LCH.Clearnet to close and sell all client positions, and within the first five days it had reduced market risk by 90 per cent, although Lehman had defaulted on OTC interest rates swaps with a notional value of \$9 trillion. The Lehman margin not used in the management of the default, amounting to several hundreds of millions of pounds, was passed on to the administrators of Lehman. By contrast, even a year after the Lehman collapse, there were still outstanding problems in related OTC bilateral trades which had not been cleared.

Changing markets

NYSE Liffe, the international derivatives business of NYSE Euronext, has provided some perspectives for this book in how exchange trading of derivatives contracts has developed in the credit crisis. In 2009, the unprecedented government borrowing as a result of the crisis and uncertainty about the future direction of interest rates created interest in NYSE Liffe's interest rate derivatives contracts. The biggest of these on this exchange are short sterling and Euribor contracts. For Euribor, the interest rate is on a three-month deposit of €1 million and for short sterling, the interest rate is on a three-month deposit of £500,000. The money that ultimately changes hands is the interest one would pay or earn on those sums in the three-month market. Most importantly, these contracts are used to hedge interest rate risk.

The exchange says that unprecedented market volatility has discouraged trading in some individual equity futures and options contracts, especially by retail investors, but is powering growth in the FTSE Index futures, which allow investors to take a macro look at the market.

NYSE Liffe's major competitors, including Eurex and CME Group, are physically located outside London. According to NYSE Liffe, the competition among derivatives exchanges is increasingly for liquidity rather than over specific products. It is not, for instance, about German government bonds, but for the traders who make those markets liquid. On this basis, fast trading networks and trading platforms matter.

NYSE Euronext is installing its Universal Trading Platform. One point of access will give customers access to all the NYSE Euronext markets, whereas

before they might have had to have various different bits of software and hardware to link to them. A customer in London who trades on NYSE Liffe but not the group's US options platform, NYSE Arca Options, will be able to access that market without having to install new technology. In addition, NYSE Liffe offers colocation facilities in New York and outside London. This brings the trading engine as close as possible to the matching engine, which runs the market, so enabling faster trading.

European regulation

The problems in the uncleared OTC derivatives market, coupled with the demonstrable performance of exchanges and clearing houses throughout the crisis, have sparked political and regulatory pressure for more derivatives trading to be standardised and cleared.

In October 2009, the European Commission published a provisional version of its communication, *Ensuring Efficient and Sound Derivative Markets: Future policy actions*. The aim was to increase derivatives market transparency, reduce counterparty and operational risk in trading, and enhance market integrity and oversight. One way the European Commission proposed in its paper to increase transparency was to require trading of standardised derivatives on exchange.

Large companies have argued that standardisation of OTC products would make it expensive for them to hedge positions and would expose them to more risk. Some dealers have said that the proposals are based on a false assumption that a non-standardised contract is necessarily risky and complex, when in some cases it can simply mean a different maturity date.

Meanwhile, the industry is taking steps to set up central trade body repositories to store OTC trade data, which will give regulators a fuller view of where risks lie. It remains unresolved how many repositories are needed and where they should be located, including between Europe and the United States. There is a case that they should be set up according to asset class, rather than geographical location, to avoid replicating data.

Derivatives for retail investors

Introduction

Retail investors use derivatives for speculating and hedging in the same way as professionals, but have less access to over-the-counter (OTC) products. They trade in much smaller sums and have a narrower range of products at their disposal. In Chapter 8, we saw how derivatives work. In this chapter, we focus on those that are relevant for retail investors, which are options, futures, warrants, contracts for difference and spread betting.

Options

Options may be OTC or exchange traded (see Chapter 8). If you are a retail investor, a traded option on exchange is accessible. It enables you to bet on the movement of individual shares, or of indices, currencies, commodities or interest rates, or may be used for hedging. Through an option, you have the right to buy or sell a security at a predetermined price, the exercise price, within a specified period.

The option is geared, which means that the underlying share or other asset is under control for the comparatively small upfront cost of the premium, which is the market price of the option. The premium is a small percentage of the option's size. For every buyer of an option, there is a seller, also known as a writer.

An option buyer on completion will pay an initial margin, which goes to the writer of the option. This initial margin is calculated to cover the worst loss in a day that could arise. The option buyer must regularly top up the initial margin to any extent that his or her position has declined in value to an uncovered level.

If the investor does not exercise the option, the premium that they have paid will be lost to the writer. But if it is exercised, the writer must provide the underlying financial instrument at the exercise price. One side will gain and the other will lose, but neither has the odds intrinsically in its favour.

You can buy a *call* option, which gives you the right, but not the obligation, to buy the underlying security at the exercise price. If the asset price is more than the exercise price of the option, the difference represents the option's value, and the option is *in the money*. If the asset price is less, the call option is *out of the money*. If you buy an option deep *out of the money* and the underlying price moves a lot, the premium could move in absolute terms much less, but in percentage terms more proportionately.

As the buyer of a *call* option, you will make money if the price of the underlying share moves up so that it becomes higher than the exercise price plus the premium that you have paid. In this case, you could sell the option and realise the profit on the options trade, but it is usually simpler to trade it as a profit.

You can buy a *put* option, which gives you the right, but not the obligation, to sell a security at the exercise price. If the exercise price is higher than the underlying security's current market price, the option is *in the money*. If it is lower, the option is *out of the money*. You will make a profit if the option price falls to below the level of the exercise price plus the premium that you have paid.

The extent to which the underlying stock's value surpasses the option's exercise price is known as intrinsic value. An option only has intrinsic value when it is *in the money*. The time value of an option is its total value less intrinsic value. The more time an option has until it expires, the higher this figure is likely to be, as the price of the underlying stock has more chance of changing in the option buyer's favour.

The premium consists of both intrinsic and time value, both of which can change constantly. These are factors used in the Black–Scholes model, which was developed in 1973 and is widely used in financial markets for valuing options. Other factors used in the model are volatility, the underlying stock price, and the risk-free rate of return. But Black–Scholes makes key assumptions that are not always tenable, including a constant risk-free interest rate, continuous trading and no transaction costs.

Equity options tend to come in the standard contract size of 1,000 shares. To find the cost of an option contract, multiply the option price by 1,000. If a call option is priced at 70p, it will cost £700 per contract. The contract size may vary if the underlying company is involved in a capital restructuring, such as a rights issue.

The options on NYSE Liffe, the London-based exchange, have expiry dates grouped three, six or nine months ahead. A first group of companies has the

expiry dates of January, April, July and October; a second group has February, May, August and November; and a third group expires in March, June, September and December. In any given month, options for only a third of the relevant companies will expire. When, for instance, a contract expires in March, a new one is created for expiry in June.

Options on stock market indices, known as index options, are essentially contracts for difference (CFDs) (see below). They are riskier than equity options as they often trade for larger amounts; perhaps several thousand pounds per contract against several hundred pounds. They are also more volatile.

The interest rate option enables traders to speculate on or hedge against interest rate risk. The price level of a contract is derived by subtracting the interest rate from 100. An interest rate of 5 per cent means that the contract is $100 - 5 = 95$ per cent. Settlement is on a value per fraction of a percentage change in interest rates. Because of the price structure, the higher the interest rate rises, the further the contract price declines, and the reverse.

Futures

Futures are a binding agreement to buy or sell a given quantity of an asset at today's price by a specified future date. The market has become increasingly open to private investors, and has made available some small-sized contracts and packaged futures products.

The futures market started in the United States in the early to mid-19th century, when mid-West farmers sold their future crops at a fixed price in Chicago. By this early form of commodity futures, the farmers had a guaranteed sale and a certain profit. The traders who bought from the farmers were speculators who hoped that the crops would be worth more on the sell date than they had paid.

Today, futures could be on commodities such as cocoa or coffee, or, since the 1970s, financial futures. The trader who goes long or short on a contract will put up an initial margin rather than the entire value of the contract, and it may have to be topped up, using the same principle as for options or spread bets. The trader can place a stop loss to sell an offsetting contract at a price that has fallen to a specified level or, should the market have fallen too rapidly to enable this, at the best price available.

In theory, a trader can run a futures contract to expiry, but in practice, they will usually trade it. If you have bought a contract, you will sell it, or if you have sold, you will buy. For details of commodities futures, see Chapter 13.

Financial futures are based on a financial instrument such as a bond, share, index, interest rate or currency, and the agreement is to exchange a cash sum

reflecting the difference between the initial price of the underlying asset and its price on settlement. Interest rate futures enable buyers to hedge against adverse movements in interest rates by buying a future to offset it. Contracts on indices or on interest rates cannot go to delivery, and any buyer or seller who does not close the position is closed out by the clearing house. Most major bond futures contracts can go to delivery.

Warrants

Covered warrants are an exchange-traded packaged derivative designed mainly for retail investors, and have been popular for some years in continental Europe. The London Stock Exchange (LSE) introduced them in late 2002 in an early move to obtain a significant presence in derivatives after its failed attempt the previous year to buy the London International Financial Futures Exchange (LIFFE). So far, covered warrants in the FTSE-100 index have proved the most popular in a market that has been slow to take off.

The covered warrant is a security and not a contract. As with options, traders in covered warrants pay a small premium, which is the amount they pay for the right to buy or sell the underlying asset, and the warrants are split into calls and puts. As time passes, the covered warrant becomes less valuable, which is reflected in a declining premium. Every covered warrant is normally traded before its maturity date, and is covered because the issuer covers its position by simultaneously buying the underlying stock or financial instrument in the market.

Covered warrants are expensive compared with some equivalent derivative products and cannot be shortened, but the spread (the difference between the buying and selling price) is often narrow, and the packaging is user-friendly. The LSE says, 'In theory, private investors could go straight to the banks and get a similar product created for them over-the-counter. In reality, they would not have the knowledge to get the product specified for them, and the banks wouldn't issue anything at such small values.'

Unlike in CFDs or financial spread betting (both covered later in this chapter), a trader cannot lose more than 100 per cent of their money, and at the end of the term, covered warrants that are in the money are automatically closed out on the investor's behalf. No stamp duty is payable on purchase, and owners will receive no dividend from the underlying shares. Capital gains tax is payable.

Some warrants are traded on the Central Warrants Trading Service (CWTS) platform, which is part of SETS, the LSE's electronic order book, and the product may generally be traded via retail service providers (RSPs). For more on trading systems and RSPs, see Chapter 15.

The covered warrant should not be confused with the conventional warrant, a product that may be used to buy a specified number of new shares in a company at a specified exercise price at a given time, or within a given period. Companies like to issue conventional warrants because they do not need to include them on their balance sheet. They are not part of a company's share capital and have no voting rights. Sometimes, the warrants are packaged as a sweetener to accompany a bond issue. They tend to rise and fall in value with the underlying shares, sometimes exaggerating the movement. Capital gains tax is payable on profits.

Financial spread betting

To take a spread bet is a way to trade on the movement of stocks, indices or other financial instruments. You may bet on futures, or sometimes on the underlying cash products. Spread bets are accessible even to the least sophisticated traders, and on small sums of money. The market is OTC, and the party issuing the bet is always the counterparty. The firms offering spread betting are regulated by the Financial Services Authority, which has cracked down on some misleading advertising from the industry.

The financial bookmakers are execution only, which means they cannot advise you on how, or whether, to bet, although they may offer data and working examples. Traders who use spread betting firms are almost entirely male, with a leaning towards the 25–35-year-old age group, and those who work in information technology.

As a trader, you may place a bet based on your belief that a share price, an index or interest rates will move up or down. Spread betting and CFDs (see under the next heading) make it possible to take a short position, which is a position that will profit if the underlying instrument goes down in value. Short selling is effectively closed to private investors in conventional share trading, because of the short standard settlement period.

Spread bets are geared and, as a trader, you need to put up only an initial margin, perhaps 10–15 per cent of the underlying value, but will need to top up the amount should the trading position move against you, on the same principle as for options or futures. You will gain or lose as a percentage of the underlying price movement. Because of the gearing, price movements can quickly wipe out the margin or more, or can make a large profit.

You can take a spread bet on a wide range of financial instruments, but shares and indices are the most popular. These can include US traded stocks through American Depository Receipts (certificates issued by a US bank representing shares in a foreign stock that is traded on a US exchange). Some bookmakers offer a grey market in pending popular new share issues (see Chapter 7). Bets are

available on foreign exchange, treasuries, commodities and other products, allowing multiple exposures. The spread betting firm may hedge its own position, using futures or CFDs.

As a trader, you may nominate a unit stake, which on a small transaction is typically £2–£5 for a single point, or may take a very large position on putting up the required margin. The difference between the price at which you place a bet and that at which you close it out is your profit or loss. If you have made a gain, the spread betting firm will deposit it into your account.

Traditionally, spread bets have been on futures and options that, by anticipating movements, are likely to move faster than the underlying share price. In 2002, CMC Markets started rolling spread bets where the basis for pricing a spread bet is the cash price of the underlying instrument, and other large book-makers now offer a similar product, at least on large stocks and indices.

In all cases, you will pay neither fees nor commissions to the spread betting firm, but spreads are at its discretion. Critics say that spreads on futures bets are too opaque and enable dealers to change them as it suits them for individual trades, making CFDs more effective. The industry's typical advice is that, when you ask for a two-way quote on the telephone, you should not reveal whether you are a buyer or seller.

Rolling cash bets have a much tighter spread – the difference between the buying and selling price – than forward bets (that is, bets on futures), and it can be the same as when you buy directly in the cash market. A rolling cash bet on Vodafone has a spread of a quarter of a point at the time of writing, which is the same as on its shares.

Spreads, even as narrow as this, are one way in which spread-betting firms make their money. A second way is through overnight lending charges to traders on rolling cash bets, which are based on 100 per cent of the underlying money. The daily charge is typically LIBOR (London Interbank Offered Rate – at which banks can borrow from other banks) plus perhaps 2 or 3 per cent, which is divided by 365, representing days of the year.

It is a small daily sum, but on an aggregate basis from all customers, it makes a profit for the spread-betting firm. If you take a short position, it is the *firm* that pays interest on overnight positions. The firm pays no interest on deposit accounts where the margin is placed, or perhaps, if the margin is sizable, will offer a low rate, which means it can use the money so saved more profitably.

If you take a spread bet on futures rather than on the cash price, you will not have to pay overnight borrowing charges, as the spreads are larger, covering *cost of carry* as well as the firm's expenses and profit margin. If the underlying shares will go dividend before the forward dealing date, the forward price is reduced accordingly.

Spread betting, like other derivatives, may be used for hedging, but it mostly attracts speculators. You cannot enter a bet with one firm and close it with another, but you can enter two bets simultaneously with different firms. Canny speculators have two or three accounts with financial bookmakers in an effort to get the keenest prices.

Investment banks, aggravated by the disproportionate impact of spread bets on new issues, have dismissed the industry as little more than simply betting. The point is open to dispute. For instance Clive Cooke, chief executive of City Index, a major spread-betting firm, said that he did not consider spread betting to be betting, but rather trading and money making (Cave, 2007).

Taking out a spread bet has two clear advantages over investing directly in the stock market. Traders pay no stamp duty on purchases, and profits will be free of any applicable capital gains tax. The tax advantage is the only significant reason why some switch from spot-trading foreign exchange to spread bets given the spreads are the same, financial bookmakers say.

Spread-betting firms will apply a stop loss for traders free of charge. A financial instrument can fall too fast to apply the stop at the set percentage level. The reliable solution is to use a guaranteed stop (unavailable on traded options), but traders will pay a premium for this in the form of a wider spread. Some traders also use a limit order to close a profitable bet at a predetermined level.

There are 400,000 financial spread betting accounts open, with an annual 25 per cent growth rate, according to a June 2006 paper (Brady and Ramyar, 2006). Financial bookmakers specialise. If a trader wants to place a more unusual bet, it may be sensible to go to IG Index (www.igindex.co.uk) or for a low-size bet, Finspreads (www.finspreads.com).

How much further the industry can expand depends partly on whether it can overcome the stigma attached to betting, say traders within firms. It is unlikely that spread betting will reach beyond the United Kingdom in the foreseeable future because of difficulties in online gaming legislation in other countries. In contrast, CFDs have an international presence.

Contracts for difference

A CFD is a contract between two parties to exchange the difference between the opening and closing price of a contract, as at the contract's close, multiplied by the specified number of shares. It provides you with exposure to the price movement in, among other possibilities, a stock or index without ever owning the underlying instrument. If the price of the underlying shares goes up or down, as a trader in CFDs, you will make or lose money on the movement.

Like spread betting, CFDs are an OTC market, which means the counterparty is the product issuer. But unlike spread bets, the CFD aims to replicate all the financial benefits of share ownership except for voting rights. As a trader, you are entitled to dividend payments and, depending on your broker, will have full access to corporate actions, including rights issues and takeover activity.

CFDs are offered by spread-betting firms, CFD market makers, specialist brokers and online dealers. The market now accounts for more than 20 per cent of trading by volume on the LSE. CFDs have expanded their coverage to include almost any market or any kind of asset. There are CFDs based on indices, currencies and commodities, and in all UK stocks with a market capitalisation (share price multiplied by the number of shares in issue) of over £50 million, many US and European stocks, and all major world indices.

The market attracts institutional investors, particularly hedge funds (see Chapter 19), and enables them to take a position in equities without revealing their identities. By direct market access through brokers, the traders often obtain keener prices than through spread-betting firms acting as market makers, but the deal will have to be of a specified minimum size.

In recent years, private investors have become increasingly involved in CFDs, but unlike spread bets, this product is open only to experienced investors. As with other derivatives, the CFD is traded on margin, which is required to be high for stocks outside the FTSE-100, and low for indices.

As a trader with a long position in a stock, you will pay a financing charge (perhaps LIBOR plus 1.5 per cent) for the outstanding amount above the margin, pro rata to the annual rate. If you have a short position, the firm will pay you the interest (perhaps LIBOR minus 2.5 per cent) for this. If you close out the CFD intraday, financing payments will not apply.

The CFD has no settlement date, unlike futures and spread betting where the contract on expiry must be rolled over to the next one. As in spread betting, there is no stamp duty payable on a CFD purchase, but after it has been held for about 60 days, the amount saved this way compared with owning shares is eroded by interest payments. From this point, it makes no economic sense to continue holding a CFD unless it is significantly increasing in value.

Unlike in spread betting, you are liable for capital gains tax on profits beyond the annual exemption level (£10,100 in 2009–10), but you may offset losses against future liabilities.

Wholesale market participants

Introduction

Wholesale markets cover short-term interest rate instruments, credit, foreign exchange and commodities, in both the cash markets and derivatives. In this chapter, we explain the role of market participants, which are banks, investors and inter-dealer brokers.

Banks

In City jargon, banks are on the *sell* side, which means that they sell to funds, investors and other customers, who are on the *buy* side. The banks employ traders in derivatives, money market instruments, foreign exchange, bonds and equities.

The traders complete transactions with traders in other banks, sometimes for their own bank, which is proprietary trading, and sometimes for a client, in which case they will sometimes use an inter-dealer broker (see below). Traders will specialise in a particular area. For example, traders might work on the short-term interest rates (STIR) desk, where they will trade repos, cash, certificates of deposit, forward rate agreements and very short-term interest rate swaps. The products are all driven by interest rates, and the dealers will try to arbitrage between them.

The banks described as first tier, which denotes a large size, are the main market participants. The second-tier banks are not so large. Third-tier banks offer banking facilities to corporate customers, but are in their turn customers of the larger banks. Hanky Panky Bank in Lithuania, for example, may have a client that knows local fish farming and wants to hedge its business with derivatives.

The bank will not have a foreign currency book, so will offset the risk by working through a bigger bank.

The banks will have their own strengths and weaknesses, often for historical or geographical reasons. For example, Royal Bank of Scotland has been strong in the freight derivatives market because of its long track record in providing services to the shipping industry.

Investors

Investors who buy products are the *buy* side. They could be companies, investment funds, pension funds, hedge funds or insurance companies (see Chapter 18).

Inter-dealer brokers

Banks do not always use inter-dealer brokers, particularly in liquid markets. On swaps, banks deal directly with each other about half the time, but the rest use a broker as intermediary, according to market sources.

If traders use such a broker, they can buy or sell anonymously, which can be useful if the seller does not want the buyer to know the price of a previous deal, or whether one was done at all. If it were known such a deal was done more cheaply, it would set a precedent.

The inter-dealer brokers serve mainly first-tier and sometimes second-tier banks. They trade in a number of products, including derivatives, money market instruments, bonds and foreign exchange. They used to be known as money brokers due to their involvement in the money markets. The inter-dealer brokers do not lend or borrow, or take a principal position. They charge a small commission and arrange the deal, much like estate agents.

At large firms, the individual brokers are organised so that distinct groups cover specific areas of the market. One desk is for credit derivatives and another is for interest rate derivatives. The desks are situated next to each other in an open-plan style. This enables brokers sitting at one desk to communicate with those sitting at another, which is useful because, for example, bond trades may affect credit derivatives trades. At the large inter-dealer broker ICAP, there is a desk for foreign currency and over-the-counter (OTC) foreign currency options. Products are also separated into currency clusters, so, for example, a dollar-based cluster will include desks for repos and other products in dollars.

The brokers shout at each other across desks, which, coupled with sound from telephone speakers, creates a buzz on the trading floor. It is useful for one

desk to know what trades are being done on another because they may have a knock-on effect.

Markets are becoming more electronic, which means that trading is faster and more automated, and detects opportunities that might otherwise have been missed because of the complex mathematical calculations dealers would have had to make under time pressure.

In the highly liquid inter-dealer market for on-the-run US Treasuries (the most recent batch of Treasury securities of a given maturity), more than 99 per cent of trading is now done on electronic platforms. Repos, another highly liquid market, are traded electronically.

Electronic platforms efficiently extend beyond the trading floor to the back office via straight-through processing, which is also now used in markets where voice trading prevails. Trades are routed through to clearing and settlement by straight-through processing, with integration into the risk management system, feeding real-time updated information to the trader about their position and the day's profit or loss in a given position.

The less liquid the market, the more likely it is that a voice broker will be used. For example, OTC options are less liquid, and such tailor-made products lend themselves more easily to voice broking than electronic trading. The broker is paid on commission for deal execution, the amount reflecting how easily and quickly deals go through, which can vary enormously.

In the chapters that follow, we shall look at interest rate products, credit products, commodities and foreign exchange. Banks trade these from one floor, although separately.

Interest rate products

Introduction

In this chapter, we shall focus on the money markets. We shall look at debt securities, including certificates of deposit, commercial paper, bills of exchange and floating rate notes. We look at the repo market, government bonds and interest rate derivatives.

Money markets

Money markets are wholesale markets, with no fixed location, where governments, banks, other financial institutions, investors and companies lend or borrow short-term money. It is corporate cash flows that determine how much use is made of the money markets, and when. If a local authority lender borrows on the 15th of the month and pays salaries on the 26th, it will lend the cash on the money markets between these dates.

In normal times, the money markets are highly liquid. They consist of lending between banks on the interbank market, trading debt securities, and the repo market.

The interbank market

Lending on the interbank market can be in very short-term money, overnight or at call, meaning that the lender may call the loan back at any time or at short notice. In London, the overnight borrowing rate for the euro is the EURONIA, which is the Euro Overnight Index Average, and for sterling, it is SONIA, which is the Sterling Overnight Index Average.

Banks may also lend money to each other for a few weeks to a year, on the interbank market. In this way, banks with extra cash lend to others short of cash. The deposit rate is the bid rate and the lending rate is the offer rate. The interbank rates in London are the London Interbank Offered Rate (LIBOR) and the London Interbank Bid Rate (LIBID).

LIBOR is the average of rates at which banks will lend. For example, a bank could lend at LIBOR + 30 basis points, which is 0.3 of a point above the LIBOR rate. Countries in the euro zone use EURIBOR in the same way. The LIBOR rates are based on supply and demand as banks lend to each other daily to balance their books. The interbank rates can vary with time, but the most widely used maturity is three months. LIBOR could be in a variety of currencies.

In addition to the above, there is trading in debt securities. This may be in short-term Treasury bills, with the Bank of England selling three- and six-month bills weekly by auction to banks. Other such securities include commercial paper, certificates of deposit, local authority bills and bills of exchange. Money market instruments are typically sold at a discount and redeemed at the full price, so enabling the market to talk about a discount rate, and a yield.

The financial crisis

Hedge funds, banks and others borrow extensively on the money markets. When two Bear Stearns hedge funds in July 2007 explained a hit to their portfolios from sub-prime mortgages, the money markets stopped functioning properly and the central banks had to intervene. Seizure of the money markets caused the subsequent problems at Northern Rock.

The September 2008 collapse of Lehman Brothers led to further problems in the money markets, on which it had sold its commercial paper. Concerns arose also about the safety of corporate bonds issued by the banks.

At this point, there were various government efforts to shore up financial institutions and the money markets. The cost of borrowing on the money markets soared, which in turn made some corporate and consumer loans, including variable rate mortgages, expensive.

Usually, LIBOR rates in the market are a fraction of a percentage point above official LIBOR rates. At times in the credit crunch starting in 2007, however, they reached 1 per cent above the official euro rate, more than 1 per cent above the UK rate, and 2 per cent over the US rate.

Debt securities

Let us take a look at the debt securities that borrowers can issue on the money markets. Some securities such as certificates of deposit are issued at par, which is face value, and others, including Treasury bills, bills of exchange, local authority bills and commercial paper, are issued at a discount.

Treasury bills

The Debt Management Office (DMO), established in April 1998 as an executive agency of HM Treasury, sells one-month and three-month Treasury bills on the government's behalf every Friday in a tender offer to banks, and sells six-month bills once a month. The Treasury bill is issued in sterling at a discount to face value, and the face value is later repaid, the difference being the equivalent to interest paid.

The Treasury bill is traded less than it was in the past because the United Kingdom, as a developed country, can borrow for longer periods. This is cheaper than borrowing for the short term, based on the inverted yield curve that reflects a decline in bond yields as the maturity extends into the future. Issuance of bonds, which is long-term borrowing outside the money markets, is therefore in demand.

The euro bill is similar to the Treasury bill but is issued in euros. The Bank of England issues three- and six-month euro bills, which helps it to fund its euro liabilities.

Certificates of deposit

The certificate of deposit (CD) is a highly liquid money market instrument distinguished by its maturity date and its fixed interest rate. A bank or building society issues the CD, certifying that the CD holder has deposited the money with it. The issue is typically for at least £50,000 with a five-year maturity, and it need not be repaid until maturity. The lender may sell the CD before maturity on a valuation based on market conditions, meaning that they may receive more or less than the amount invested.

The local authority bill is a discounted short-term loan, issued by local government bodies in the money markets as a non-tradable instrument, with a maturity of up to six months. The market is far weaker in the United Kingdom than in the United States.

Commercial paper

Companies issue commercial paper. This is an unsecured short-term loan with a minimum £100,000 denomination, issued at a discount to face value, and the

borrower which undertakes to repay at the face value. The loan has a life of up to one year, but it can be rolled over. It is a bearer note, which means that ownership is transferred only in paper form, and whoever physically holds the note on maturity receives the repayment.

Bill of exchange

The bill of exchange is a promise to pay for goods sold in a specific transaction. It works as follows. A creditor company draws up a bill and presents it to the debtor company, which signs it to acknowledge its debt, and a payment deadline may have been specified.

The creditor may hold the bill or sell it to a third party that will collect the debt. A bank, known as an accepting house, may have put its name on the bill, so accepting responsibility for paying the bill on maturity. Bills of exchange were once bought by discount houses, but these no longer exist, and this form of debt security is now less widely used.

Floating and fixed-rate notes

A company may issue a floating-rate note as an alternative to bonds. The note pays regular interest through a floating-rate coupon, typically reset every three or six months in accordance with LIBOR or another standard money market rate. It typically has a five-year maturity. If a bank lends at floating rates, it may have borrowed to match this.

A fixed-rate note pays interest regularly through a fixed-rate coupon, with a higher rate than on a floating-rate note of the same maturity.

Both floating and fixed-rate notes pay a return expressed as an annual interest rate.

Repos

Classic repo

The classic repo (see also Chapter 2) is a sale and repurchase agreement, and a reverse repo is the opposite transaction. The repo is a short-term secured loan in the money markets, sometimes between banks and the Bank of England, and at other times between financial institutions.

The recent popularity of the repo has reflected a shift in the money markets from unsecured to secured lending, where bigger sums may be borrowed. The 1990s banking crisis in Japan and recent banking problems in Germany have driven this trend.

Let us look at how the classic repo works in the United Kingdom. The banks are sitting on large portfolios of mainly government bonds, which they need to hold for reserves, with low yields and high collateral value. Sometimes a bank borrows money from the Bank of England for a stated period, perhaps 7, 14 or 28 days, and provides collateral, usually in government bonds.

The Bank of England will, if it wishes, take the eligible security from the bank and lend money against it as part of the open market operations (OMOs), through which it determines and implements repo rate changes. The Bank will return this collateral to its owner at a future date at a specified higher price, the difference being the interest payable. The collateral is typically 2 or 3 per cent more than the loan, and it is almost never called. For £100 loaned, the collateral may be £103, and the £3 difference is known as the *haircut*. The Bank cannot recall a default on repos.

A debate rumbles on about how far central banks, in selecting bonds as collateral in the repo market, should differentiate between risk profiles. Bonds issued by the Italian government have had lower credit ratings than those issued by the German government, which implies that Italy has a higher chance of defaulting on its debt than Germany, but the European Central Bank has controversially accepted the bonds of both countries equally as collateral.

Sell/buy-back repos

Besides the classic repo there are sell/buy-back repos. The sell/buy-back repo is the sale of a bond on the value date and a purchase of it for value on a forward date. The buying and selling price are different, whereas in the classic repo, they are the same, only with interest built in.

Securities lending

Securities lending is another variation. This is a temporary exchange of securities for collateral, and is not technically a repo. Institutional investors will lend their bonds for a fee to enhance the income from their fixed interest portfolios. The borrower must provide cash, securities or a letter of credit as collateral to the lender.

Interest rate derivatives

Interest rate derivatives are the main instrument in the OTC derivatives market. They enable companies that have made large borrowings to protect themselves against adverse interest rate movements, and are a major part of the money markets.

According to Bank for International Settlements data, interest rate contracts globally at the end of 2008 had a notional amount outstanding of US\$419 trillion, representing 71 per cent of all OTC derivatives. In recent years, interest rate contracts have similarly accounted for around 70 per cent of all contracts.

Index swaps

Behind repo transactions, the second most prominent type of trade in the money markets is the overnight index swap, where fixed rates are swapped for floating rates, with the floating rate set according to SONIA or the EURONIA.

Forward rate agreements

The forward rate agreement (FRA), which came to the market in the 1980s, is a contract between counterparties to pay or receive the difference between a floating reference rate and the fixed FRA rate, agreed in advance. It is for a single forward period only, while the swap is an agreement for many forward periods. A number of FRAs are the equivalent of a swap.

The FRA is sold with a bid–offer spread, and some banks will buy FRAs at one rate and sell them at another. According to inter-dealer brokers, banks tend to prefer FRAs, which are OTC traded, to futures, which are exchange traded. The FRA is a medium with which they are familiar, is easy to trade through brokers, and is flexible on delivery date.

Banks with a low credit rating find FRAs expensive, however, and look to cover interest rate exposures through futures, where the same institutional pricing is available to all the banks. The futures market tends to be aligned with the cash market through arbitrage.

In the past, swaps and FRAs, when used for hedging, had been off the balance sheet, allowing a deferred profit or loss. Now, International Financial Reporting Standards (see Chapter 27) require that all derivatives be accounted for at fair value on the balance sheet and marked-to-market through the profit and loss account.

Interest rate forwards

The interest rate forward, sometimes called a ‘forward for an exchange’, is when two counterparties agree to borrow or lend a fixed cash sum at an agreed rate for a specified period starting on a future date.

In the past, it had to be recorded on the balance sheet because it was based on real money, which meant it was used less than the FRA. Now both types of contract are on the balance sheet, and the distinction no longer applies.

Government bonds

Bonds are short- to long-term debt vehicles. As an asset class, they are more stable than equities, although they show much lower long-term gains. Pension funds and insurance companies (see Chapter 18) are the largest traditional investors because bonds can help to match their liabilities more precisely than equities or other instruments. Rates on annuities (see Chapter 32) are linked to bond returns. Mutual funds, central banks and high-net-worth individuals favour bonds.

The DMO issues gilts, which are UK government bonds, in the wholesale market so that the government can fund its annual net cash requirements and make gilt redemptions (the amount paid back to investors when gilts mature). National Savings and Investments offers retail savings products to the retail market, and the Bank of England issues foreign-denominated government bonds.

Gilts are considered as risk free as you can get; the UK government has never defaulted on its debt obligations. They are classified according to when they mature. Gilts maturing in 1–7 years are classed as short term; if they mature in 7–15 years, they are medium term; if they mature in more than 15 years, they are long term.

There are about 50 gilts currently in issue, conventional and index linked. Conventional types, which account for approximately 75 per cent of the gilt portfolio, are fixed coupon, which means that they pay a fixed amount of annual interest. There are three older double-dated conventional gilts, which means that the government may repay the principal at any time between the two maturity dates given; they account for less than 0.3 per cent of gilts in issue.

The remaining 25 per cent of UK gilts are index linked, which means that they are guaranteed to keep pace with inflation. The principal amount is increased if the Retail Prices Index, an inflation measure, should rise. The interest rate would rise accordingly because it is applied to the principal. On the gilt's maturity, the principal is repaid at the increased amount.

Holders of conventional fixed-coupon gilts require a higher yield than holders of index-linked gilts to compensate for the greater risk.

About 0.71 per cent of gilts are undated, which means that redemption is at the government's discretion. Because these are the oldest gilts in issue, they have low-rate coupons. The government has little incentive to redeem such borrowing while it is cheap, and investors can retrieve their capital only by selling to other investors.

Yields and redemption

Bonds pay interest through a coupon, which is the annual rate of interest on the bond and is stated as a percentage of the nominal value. The coupon will have been decided by the level of interest rates in the market at the time of the bond issue.

If a bond offers a 3 per cent coupon, it will pay £3 a year in interest for every £100 of nominal value. Gilts pay the coupon in two instalments per year.

On redemption of a bond, the bond issuer repays the principal sum at nominal value or par, which in the case of gilts is £100. In practice, the bond will have started its trading life at par, or close to it. The market price may deviate from nominal value at any time in the bond's life.

The dividend yield that investors receive from buying a bond on the secondary market can vary from the coupon because it consists of the return expressed as a percentage of the bond's price, which can fluctuate from the nominal value. The yield can be expressed in different ways.

The current yield is the annual interest of a bond, divided by the current bond price. It is also known as the running yield, flat yield, simple yield or annual yield. The higher the bond price rises, the lower the current yield will be, and conversely, the lower the price falls, the higher the yield.

The gross redemption yield, also known as yield-to-maturity, is widely used to compare the returns on bonds. It is the current yield plus any notional capital gain or loss at redemption.

In the period between interest payments, interest accrues on a daily basis. A buyer of bonds in the secondary market pays not just for the financial instrument, but also for any income accrued since the last interest payment. This is cum (with) dividend. If they buy it ex dividend, it is the seller who will have retained the right to the pending interest payment.

Gilt prices may be quoted either clean, where accrued interest is added later to the bargain because it has been excluded in the price, or dirty, where an accrued interest adjustment is already included in the price. Issuance of the bond may be timed so that capital repayment will coincide with anticipated income from specified projects. An exception is the undated bond, which is not redeemed.

Conventional gilts are repaid at their nominal value, and so the price moves towards this level as the redemption date approaches. This is the 'pull to redemption' or 'pull to par' effect. As interest rates go down, bonds rise in value, and when interest rates are up, the price of bonds falls. But the closer bonds are to maturity, the less influence this will have in comparison with the pull to par.

On this basis, long-term bonds, particularly if undated, are more exposed to interest rate fluctuations because redemption is further off. If you think interest

rates will go down, you should buy long-term bonds. The yields are generally higher to compensate for a perceived greater risk, despite the inverted yield curve discussed earlier.

A bond may often be callable, which means that the issuer, usually a company, may redeem it before maturity. If interest rates should decline, the issuer is likely to call the bond and reissue it at a lower rate of interest. The investor would then be left with money to reinvest in a world where interest rates are low. To compensate for this *reinvestment* risk, the callable bond will often pay a high coupon.

Market size

In the first years of the DMO's operations, the size of the gilt market fell as gilt redemptions exceeded gross issuance, but in 2002–03, new issuance turned positive as the government's financial requirements started to increase.

In 2008–09, the eleventh year of the DMO's operation, there was a major change in the financing environment as global financial markets deteriorated. The financial year's initial planned gilt sales programme was for £80 billion, a record in nominal terms, and this was increased to £110 billion in October 2008 as part of a programme to refinance the recapitalisation of the banking sector.

By the end of March 2009, the gilt market's nominal value reached £636.6 billion, compared with £278.8 billion in March 2002.

Borrowing and the economy

Gilts are issued by the Treasury to fund government borrowing. Before November 2008, credit default swaps on gilts had the same spread – the premium a buyer must pay to a seller – as those of other European countries. In June 2009, these swaps were priced at twice the credit risk of France or Germany.

In June 2009, Mervyn King, governor of the Bank of England, said in testimony to the Treasury Select Committee that the government was running too high a borrowing level in crisis conditions.

In the same month, the Organisation for Economic Co-operation and Development (OECD), which consists of the world's 30 most advanced economies, forecast in an economic survey of the United Kingdom that the British economy would shrink by 4.3 per cent in 2009. The OECD called for a plan to ensure that debt would decline once recovery should have taken hold.

Credit products

Introduction

In this chapter, we shall cover credit products, as distinct from the interest rate products covered in Chapter 11. We focus on corporate bonds, international debt securities, junk bonds, asset-backed securities, zero-coupon bonds and equity convertibles. We shall consider credit derivatives.

Overview

Credit products are integral to financial markets. They help to fuel merger and acquisition activity, which, as we saw in Chapter 7, can keep equity market activity high. A predator will often finance a company takeover partly through cheap debt, which has helped to keep credit markets buoyant.

In this and other ways, credit products may be seen as parts of a larger whole. For example, credit default swaps, a form of credit derivative, have a direct influence on the price of bonds, a link on which we will touch later in this chapter.

The risk with credit is that the money may not be repaid. In mid-2007, default problems had arisen with US sub-prime mortgages, which are mortgages for those with a patchy credit history, and this hit collateralised debt obligations (CDOs), which package up these mortgages and trade them. Hedge funds and other asset managers invest in these CDOs more than in the underlying assets. The problems with CDOs triggered obligations under credit default swaps (CDS), as we shall discuss later in this chapter.

Bonds

According to the IFSL (Maslakovic, 2009a), the UK corporate bond market is smaller than in many developed countries because UK corporations have historically tended to meet their finance needs through the banking system rather than the bond markets. The outstanding value of UK corporate bonds totalled £13 billion at the end of 2008. The outstanding value of bonds of commercial banks and other financial institutions was larger, and totalled £261 billion at the end of 2008, up 21 per cent on the previous year.

Corporate bonds

Corporate bonds work similarly to government bonds, and in Chapter 11 we referred to their share of the UK market. They have a risk of default and thus are not equivalent to government bonds, and so they pay slightly higher interest. Hypothetically, the yield could be 200 bps above that of gilts (bps are pronounced ‘beeps’ and are basis points, each of which is a hundredth of a per cent).

Large companies issue corporate bonds to raise cash without using up conventional credit sources. Small- or medium-sized companies do not find this economically viable. Smaller corporate bond issues are not necessarily very liquid, and this market depends on dealers committing capital.

Corporate fixed-interest bonds can be secured on specified assets, which is reassuring to investors as an insurance against insolvency. They can also be unsecured, which is most usual for international bonds (see below), in which case they have higher yields to compensate for the greater risk. Restrictive covenants may be in place to set a borrowing limit.

Investors in corporate bonds face price risks linked to interest rates, as applies to government bonds, and credit risk, which is the likelihood that the bond issuer will fail to pay interest or repay the principal. The credit rating agencies (see below) try to measure this risk, which depends on the underlying company’s financial status.

The higher the credit rating, the less interest the issuer will have to pay, a principle of credit that applies also to short-term financial instruments. Highly rated bonds are unlikely to default, although the agencies do not always agree on their ratings. The default risk increases, however, during a recession. On corporate bonds, there is also liquidity risk, which is measured by the size of the bond’s spread (the difference between bid and ask prices).

‘Junk bonds’ is an unflattering term for those bonds classified by the rating agencies as sub-investment grade. Corporate bonds might fall to junk status because of a deterioration in the issuer’s financial performance. Junk bonds pay a high yield to compensate lenders for the credit risk of the issuer, just as banks

lend on credit card receivables at a rate reflecting their default experience. Their promoters call them high-yield bonds.

Junk bonds from two companies that have the same yield may perform differently. Various forms of junk bond have been used to finance takeovers, and the product has a poor reputation. Junk bonds are not acceptable as collateral for repo trades (see Chapter 11).

The credit crisis

By late 2008, as a result of the credit crisis, investment-grade corporate bonds had fallen substantially in value, which meant their yields had risen accordingly, and they had greatly underperformed government bonds in the market. Corporate bonds of some banks such as Santander and Royal Bank of Scotland were looking cheap. Investors had lost money on these corporate bonds, including through bond funds. The yield spread, meaning the difference in yields between corporate and government bonds, had widened from 200 bps to 600 bps over the year.

Junk bonds had also declined in value, and by late 2008 had yields of over 20 per cent in the United States. By mid-2009, yields had contracted sharply and were down to 10 per cent. Because of the recession, corporate bond spreads have reacted more to changing credit risk perceptions than, as in better times, to interest rates. In this way, bonds became more correlated with equities. For UK government bonds, where there is effectively no credit risk, see Chapter 11.

Credit rating agencies

A credit rating agency rates the creditworthiness of a bond. The higher the rating, the better the credit terms a borrower will receive. The major agencies are Standard & Poor's, Moody's Investment Services and Fitch Ratings. In the United States, AM Best is a major insurance industry-rating agency.

The rating is a paid-for service, which has called into question its independence. There is supposed to be a Chinese wall between the analyst and the commercial side of the agency, but there is evidence across the financial services industry that this type of divide can break down. If a company does not buy a rating, some agencies have been known to publish it unsolicited, even if based on incomplete information.

In rating a company, the agencies have access to non-public information, and they claim to concentrate on assessing only the default risk. The criteria

used vary slightly between agencies, but include social and political risk, the regulatory environment, and the level of Westernisation of the borrower's country. Critics say that the agencies react to events rather than anticipate them.

The agencies do not always agree on their ratings, even after allowing for differences in grading structure, but bonds highly rated by the major agencies are unlikely to default. If an agency reduces its rating on a bond, the price is likely to decline.

Until recently, credit rating agencies have resisted regulation, saying that they do not need it because their business depends on the trust of the companies that pay for a rating. They have a code of conduct (IOSCO, 2004).

The 2007–10 financial crisis has shown vulnerability in the rating processes, particularly after some triple-A backed structured products proved toxic. Agencies are paid by those that they rate, and this conflict of interest became the main focus of reform – from the Securities & Exchange Commission, IOSCO and, in April 2009, the European Commission with an announcement that it would propose legislation to regulate rating agencies.

Many consider the rating agencies completely discredited. The agencies remain powerful, however. Institutional investors are restricted from investing in securities below a certain rating. If an insurance company, for instance, deals with a lower-rated reinsurer and a few years later it defaults, the insurer has no excuse. At the same time, rating agencies make mistakes, leaving aside the possibility that they have been conflicted. The message to investors is clear. They should not rely exclusively on ratings, but should do their own due diligence as well.

International debt securities

London has a large market in trading international debt securities, which include Eurobonds and foreign bonds. A Eurobond is a tradable bond with a maturity of at least two years, denominated in the currency neither of the issuer nor of the country where it was issued, and it is listed on an exchange, which distinguishes it from a loan.

The Eurobond market started in 1963 when President John F Kennedy imposed a compulsory interest equalisation tax on interest that Americans took from stocks and bonds that foreign entities had issued. It led to a move of dollar-denominated debt business from the United States to Europe. In 1974, the US requirement for this tax was abolished, but by then the Eurobond business had become established in London. Since the Euromarkets started, the International Capital Markets Association has facilitated interaction between issuers, lead managers, dealers and investors.

Large companies as well as banks, governments and financial agencies issue international bonds to borrow cheaply in a foreign market. Eurobond

issuers need good credit ratings because this type of bond is unsecured. The larger Eurobond issues are global, and are sold to high-net-worth individuals as well as institutions. Investment banking methods are used to sell Eurobonds, rather than commercial bank methods used to sell syndicated loans. A lead bank will run a syndicate of banks to underwrite the issue. A group of selling banks which need not be underwriters will retail the bonds to investors.

In practice, Eurobond issuers raise cash in the fastest and cheapest way, cherry-picking floating or fixed-rate interest structures and currency. Some issues are more liquid than others. Taking the advice of investment banks, Eurobond issuers will exchange the money flows for those that they really want through the swaps market. More than two-thirds of Eurobond issues are swapped, according to industry surveys. Eurobonds pay interest gross, which gives time for the gross interest to be invested before tax is paid. They tend to be held in book-entry form by the international central securities depositories, Euroclear Bank and Clearstream Banking Luxembourg. Ownership records vary according to whether the Eurobonds were issued in registered or bearer form.

International bonds issued in the United Kingdom in 2008 were up 42 per cent from the previous year to US\$700 billion (Maslakovic, 2009a). The outstanding value of all international bonds in the United Kingdom reached £2,376 billion in 2008, nearly twice the value of two years earlier, and Eurobonds accounted for about three-quarters of this. International bonds have been the most buoyant part of the UK bond market over the past decade, increasing their share from 34 per cent to 74 per cent of total outstanding bond values. The share of domestic corporate and financial company bonds fell from 24 per cent to 9 per cent over this period, while the share of UK government bonds fell from 41 per cent to 19 per cent.

Zero-coupon bonds

Zero-coupon bonds do not pay interest throughout their life. Investors buy them at a deep discount from par value, which they receive in full when the bond reaches maturity. The bonds give investors predictability, but the price swings easily with interest rate changes and the market is fairly illiquid. If investors should sell before maturity, they may not make a profit. Gains are subject to capital gains tax.

Convertible bonds

Convertible bonds are fixed-income securities that may be exchanged for a set number of shares. If the company's stock rises, these bonds rise in value as well.

The bond will not, however, rise in value as much, and the holder will often want to convert. If the company does badly, the holder will prefer to stay in the bonds, and if it goes bust, bond holders are repaid before shareholders.

The issuer of an equity convertible will offer a lower level of interest than on a conventional bond because of the conversion option. The option could be one of various kinds, including a US option, which you can exercise whenever you want, or a European option that you can only exercise on maturity.

An exchangeable bond gives the holder the right to convert a bond issued by one company into the shares of another.

Convertible bonds had one of their worst years ever in 2008 as many hedge funds sold out. Lehman Brothers had been a sizeable issuer and holder of convertible preferred shares, and its bankruptcy helped to spur a decline in the convertibles market. The September 2008 nationalisation of the two US mortgage providers, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Association (Freddie Mac), which were also issuers and holders of convertibles, had a similar effect. In mid-2009, some funds were looking to invest in convertibles as a low-risk way to gain equity exposure. At this point, up to about two-thirds of the convertible market in Europe was set to mature in the coming three years.

Covered bonds

Covered bonds are investment-grade, full-recourse debt instruments issued by banks and collateralised by a cover pool of assets consisting of mortgage loans and/or public sector debt. In case of default, bond holders have an initial claim against the issuer as well as a preferential claim on the cover pool of assets.

The claim on the issuer is a main advantage that a covered bond has over an asset-backed security (see below). With securitisation, the investor only has access to the underlying assets, put into a special purpose vehicle, and if there is a loss, the lower-rated tranches of those assets will take a hit. See 'Asset-backed securities' below. Covered bond issues, in contrast, have one tranche, which is usually rated triple-A, and is protected by generous collateralisation.

No default on covered bonds has been recorded since they were first issued in the late 18th century, and the bonds offer a yield that is sometimes greater than on government bonds.

In March 2008, the UK government introduced covered bond regulations with the aim of enabling issuers to compete on a level playing field in the European Union. Because it now has this legal framework in place, UK covered bonds may have a lower risk rating, meaning that they do not attract high regulatory capital charges, and funds can invest in them up to significantly higher investment limits.

Mortgage-backed securities

With mortgage-backed securities (MBSs), originators take people's mortgages and package them up into securities, so turning them into an investment product. In the United States, the mortgages can be from the government-sponsored enterprises Fannie Mae and Freddie Mac, which have a combined debt of US\$5 trillion. In September 2008, the US government put these two agencies into conservatorship, which is the US equivalent to nationalisation.

The mortgages can be sponsored by government programmes, meaning the Government National Mortgage Association (Ginnie Mae), which guarantees investors the timely payment of principal and interest on MBSs backed by federally insured or guaranteed loans. Ginnie Mae securities are the only MBSs to carry the full faith and credit guaranty of the US government.

Otherwise, mortgage-backed securities can be conventional mortgages, including non-performing loans. They may have a private label. By 2009 the federal agencies had continued to securitise mortgages, but all other securitisation activity related to private-label MBSs had virtually ground to a halt (McKenzie, 2009a).

Asset-backed securities

Mortgage-backed securities (see above) comprise first mortgages on single-family properties. Securities backed by any other kind of mortgage or loan, including commercial mortgages, car loans, credit card receivables, student loans or leases, are known as asset-backed securities (ABS).

The bonds are issued in different classes of risk and return, and the classes are rated by the credit rating agencies.

Banks originate the loans and then sell a pool of assets, which produce cash flows, to a special purpose vehicle (SPV), which is designed to protect investors from the credit risk of the originator. The SPV sells the pooled loans to a trust, which issues interest-paying securities that can have a credit rating unrelated to the loan originator. These securities fund the securitisation.

The issuer of the ABS pays interest to investors from the interest and principal paid monthly as mortgage or finance payments. If some of this income stops because the mortgage or credit card owners default on their obligations, it is the investors who will have assumed the risk.

The SPV bundles the underlying assets into specific pools that will fit the various risk preferences of potential investors. ABSs receive a credit rating based on the assets and liabilities of the SPV, which will influence the interest rate of the ABS.

Across the City, Wall Street and other financial centres, many ABSs have turned toxic, and events around this have been a major cause of the 2007–10 financial crisis.

Collateralised debt obligations

With tightening bank regulations, banks are finding it useful to transfer risk off their balance sheets to other investors, and CDOs of ABSs are a way to do this. The CDO packages up bonds that are backed by pools of mortgages and other kinds of debt, including leveraged loans used by private equity firms to fund buyouts. The CDO is sold to investors and the income from its assets is used to pay them. Investors are exposed to the risk of default, and if a default is big enough, it cascades up the scale to include the higher classes of bonds in which they are invested.

A major problem with ABS CDOs is that they have been constructed from tranches of ABSs, which are in themselves mortgage pools that have diversified the risk. The packaging of ABSs, unlike that of corporate securities, into CDOs may not provide further diversification benefits.

Some CDOs, known as CDO squared, package bonds from other CDOs to reslice and resell the risk.

The synthetic CDO is a type that is uncollateralised, involving an issue of securities on which the return is decided by reference to a portfolio of debt obligations that does not physically exist. The credit exposure and return are synthetically created by the issuer executing a credit default swap with a counterparty, which pays a monthly fee equivalent to an interest margin on the loans. If the portfolio suffers a credit event, the issuer must compensate the losses, which beyond a given level are passed on to investors.

If the buyer of CDOs fails to meet margin calls on funds it borrowed to invest in the CDOs, the lender may seek to sell the collateral for the loan, which consists of the CDOs. Higher margin requirements could lead to forced selling of CDOs or investor redemptions. The market for CDOs is not particularly liquid, and huge sell-offs of bonds can lead to a significant CDO repricing. This can also be triggered by downgrades from the credit rating agencies, which actually started in mid-2007.

By this stage, investment banks that lend money to hedge funds to buy CDOs had been raising margin requirements. In March 2008, two hedge funds owned by Bear Stearns came close to collapse because they failed to meet margin calls on CDOs made up of risky US sub-prime mortgages. This led to widespread concerns about how CDOs of ABSs were priced. Many CDOs have not been marked-to-market, which means losses are not shown for long periods of time. The pricing model used for CDOs had not accurately measured the risk, and as it turned out, CDOs played an instrumental part in the 2007–10 financial crisis.

Collateralised loan obligations

The collateralised loan obligation (CLO) is a form of securitisation where payments from business loans are pooled and transferred to different classes of owners in different tranches. CLOs offer a higher yield than similarly rated fixed-income investments.

Some leveraged loans bought by the CLO are ‘covenant-lite’, which means they have fewer or no maintenance contracts, making them like bonds. There is no requirement for the borrower to meet certain financial ratios at regular times, as set out in maintenance contracts. Only incurrence tests apply, which specify criteria that must be met during given events, such as extra borrowing or buying another company.

In the financial crisis of 2007–10, market interest in CLOs, as in other structured products, dwindled drastically.

Credit derivatives

A credit derivative is an off-balance-sheet arrangement that permits one party to transfer a credit risk in an asset it may or may not own to a guarantor, without selling the reference asset. The asset could be a portfolio of assets, and so there may be a portfolio of credit derivatives as well as a single credit derivative. Effectively, the party transferring the credit risk pays a premium for protection against a counterparty default.

The market for credit derivatives started to grow in the late 1990s and has been higher than expected, with the range of products diversifying. The range of users has expanded from just bank lenders hedging their risk to include fund managers and insurance companies. Hedge funds have contributed to the industry’s growth by their arbitrage activity.

Some back offices have struggled to keep up with product innovation in credit derivatives. In March 2009, State Street Corporation said in a report that the volume of OTC trades might prove a challenge for legacy technology systems, and that procedures to confirm, process and manage the trade life cycle of OTC derivatives needed to be automated.

Credit default swaps

Speculation using CDSs, the most popular form of credit derivative, has been a defining feature of financial markets leading up to the 2007–10 financial crisis.

The CDS is a contract where the seller agrees to pay the buyer if a specified credit event, such as a default, bankruptcy or restructuring, should arise

on an underlying entity. Investment managers have bought CDSs, paying annual premiums to protect their bond portfolios, and have also sold such insurance to others.

The CDS has been used to replicate the performance of sub-prime mortgage-backed securities and CDOs (as described earlier in this chapter), so meeting investor demand when the cash products become scarce. Some CDOs have made use of both cash positions: this applies to non-derivative and CDSs.

Large financial institutions, particularly banks, as well as the investment banking division of insurer AIG and monoline insurers, wrote CDSs to insure financial institutions against losses on CDOs. In return, the CDS writer would take a premium from the buyer. Such CDS trading was a major factor leading to the credit crisis. CDOs backed by sub-prime mortgages were loss-making on a huge scale.

To understand in more detail how CDSs work, let us take a fictional scenario. If Worried Bank wants protection on a US\$20 million bond it bought from a company, Blunder Ltd, the underlying entity, it can pass on any or all of the risk by buying a CDS from Comfort Bank.

The amount of protection bought is the notional amount. Let us say this is US\$18 million. If Blunder defaults, Comfort Bank will pay Worried Bank this notional amount, but in return for providing such protection, will have been receiving from it a quarterly premium. If credit conditions deteriorate, there will be a rise in the CDS spread, which is the annual amount the protection buyer must pay the protection seller over the length of the contract, expressed as a percentage of the notional amount, and denominated in basis points, or one-hundredths of a percentage point. Worried Bank is paying a lower premium than the market justifies, and Comfort Bank may have to post collateral for the protection it provides. If Blunder's credit condition improves, the spread will decline and Worried Bank will be paying a bigger premium than justified, which may mean that it has to pledge collateral to Comfort Bank. According to the International Swaps and Derivatives Association (ISDA, 2008), 63 per cent of all CDSs are collateralised.

In addition, Comfort Bank will have hedged the risk through buying a CDS from Extra Comfort Bank, which in turn will have hedged its own risk. This has led to talk of a daisy chain of people linked into such a transaction. If every transaction in the chain has a notional value of US\$19 million, five such transactions end up valued at a notional US\$95 million. This illustrates the market's growth, but is completely irrelevant as an indication of how much the overall payout could be, which in this case would be one payment of US\$19 million, or less if there are recoveries. In the event of a default, as in this case, there is netting-off of amounts payable and to be paid.

Meanwhile, on an institution's balance sheet, a CDS can change from an asset to a liability or the reverse, based on changes in the underlying entity's financial condition, in accordance with marked-to-market accounting.

Further CDS trading opportunities are available through synthetic CDOs, which include both prime-quality debt securities and a CDS on a portfolio of loans. An investor buys a loan issued by an SPV and sells protection through a CDS on a loan portfolio. The SPV uses the investor's cash to buy prime-quality debt securities, which give a low yield, to which is added, however, the SPV's premium for CDS protection, together replicating the yield and risk of investing in the loan portfolio. In risk terms, this is the equivalent to investing in the underlying loans.

In December 2008, CDSs had a notional amount outstanding of US\$42 trillion, which is just 7.1 per cent of the amount for global OTC derivatives.

Rights and wrongs

In 2008 Christopher Cox, then chairman of the Securities & Exchange Commission, referred to a 'regulatory black hole' for CDSs (Cox, 2008). He said that the CDS market had drawn the world's major financial institutions and others into a 'tangled web of interconnections where the failure of any one institution might jeopardise the entire financial system'. He said that the risk arose because there was a lack of information.

The debate extends beyond regulations, however, to the morality surrounding the use of CDSs in various kinds of speculation. In a 14 June 2009 blog on FT.com (www.ft.com), Willem Buiter, a leading economist and former Monetary Policy Committee member, noted that CDS sellers or buyers sometimes influenced the outcomes of the underlying bonds for commercial motives. He said this was unethical and that a buyer of CDSs who could influence the likelihood of default on underlying bonds might be tempted to allow default if it was profitable (Buiter, 2009a).

Buiter discussed an earlier case of Texas-based broker Amherst Holdings, which sold CDSs on mortgage bonds, then bought the property loans underlying the bonds to prevent a default. The bonds were paid off in April 2009 and the CDSs became worthless. Amherst made a good profit. Buiter saw this as wrong, but others, including some who responded to the blog, have seen it as an inevitable part of capitalism and besides, achieving a wanted result for CDS buyers.

The legendary hedge fund manager George Soros picked up the theme in 2009 (Soros, 2009). He said that the large profits on CDSs that

could be made, should a company default on its debt, were encouraging bondholders to bankrupt companies rather than restructure their debts. Soros said that this was like buying life insurance on somebody else's life and having a licence to kill. He concluded that CDSs were instruments of destruction that should be outlawed entirely.

The future

There is on the one hand a feeling that complex structured products have gone too far and should not be allowed to return. On the other hand, it is acknowledged that these products performed a useful role in spreading risk, and that innovation is essential for economic development. Once the crisis is over, a focus on back to basics and greater transparency will prevail, but it is hard to see these products disappearing.

Commodities

Introduction

Commodities are a growing source of portfolio diversification for mainly institutional investors. In this chapter, we shall see how commodity derivatives work and how they are traded.

Overview

Commodities, from metals to agriculture products, are a volatile asset class, correlated with the US dollar, and a driver behind the performance of many stocks. Gains can be spectacular, but so can losses.

The commodities market is derivatives driven, normally with only precious metals owned physically. The market for commodities derivatives is less evolved than for financial derivatives. There are options on commodities, although in this chapter we shall focus on futures. Industry wisdom has it that the financial derivatives market is 15–20 times the value of the underlying cash market, but in commodities this is reversed. The physical market is much bigger than derivatives.

Over time, commodity derivatives are expected to catch up with their financial cousins; traders use both markets for speculating and hedging. Commodities rise and fall in value depending on supply and demand. Commodity futures prices are ultimately aligned to those in the underlying industry, but the basis differential – the difference in the prices of the commodity and the future – will fluctuate during the contract's life, often because of panics or euphoria based on events affecting supply. Traders take huge positions, which can have a manipulative effect.

As a speculator, the trader buys a future with commitment to buying a commodity at a given price. If its value rises above the price paid, the trader

may close out the position with the opposite contract, where there is a commitment to selling the contract. By so trading before expiry, the trader avoids physical delivery of the underlying commodity, and may also sell short, seeking to gain from a downward valuation of the future's price.

The trader in commodities may pay the full amount at the start, as when buying a stock, or a small portion of the amount traded, which is known as initial margin, and will top it up if the position goes against them beyond the level covered. The trader putting up the initial margin can gain substantially in relation to this if the future rises in value, but can quickly lose everything if it declines.

Hedging activity may run parallel to the buying and selling of raw material. For example, a car manufacturer may buy futures contracts on the London Metal Exchange (LME) to provide a hedge against fluctuations in the price that it pays for metal as a buyer.

The prices for some commodity futures are included under 'Commodities', published Tuesday to Friday in *The Times*. The spot price is the present delivery price. Futures prices have varying delivery months; crude oil has 12 contracts a year and cotton has six.

The futures price on the earliest delivery month, the 'front month' contract, is closest to the spot price, but is slightly higher to include interest, dealing charges and, where relevant, the cost of storing the underlying commodity. If the gap between the futures price on the front month contract and the spot price becomes too wide, trading arbitrage reduces it.

The number of derivatives contracts traded on the exchanges has mushroomed in recent years, partly due to electronic trading, but this still lags the over-the-counter (OTC) derivatives market, where professionals carry out trades by telephone, often using inter-dealer brokers.

Amounts outstanding of OTC commodity derivatives fell 66 per cent in the second half of 2008 to US\$4.4 trillion (Gyntelberg and Mallo, 2009: 3, 7). In the same period, contracts on gold contracted 39 per cent to US\$400 billion and other commodity derivatives fell 68 per cent to US\$4 trillion.

Pension funds are the main institutional investors in commodities. Two of the biggest declared commodities investors are Sainsbury's and Hermes, owned by the BT Pension Scheme. Generally in the United Kingdom, pension funds are less keen on commodities than, for example, in the Netherlands and Germany.

Most commodities investors put their money in index funds, of which the largest is the Goldman Sachs Commodity Index (GSCI), owned by Standard & Poor's.

Private investors do not often trade commodities directly, but they can easily invest directly in energy or mining companies. Spread betting (see

Chapter 9) is a favourite way for some private investors to gain some commodities exposure. Another way is to invest in, for instance, exchange-traded commodities (ETCs), a product listed and traded on the London Stock Exchange. The ETCs are open-ended, asset-backed securities, offering a choice of index trackers (following an entire index of commodities with its particular balance) or individual commodities. They are quoted in US dollars, which carry a currency risk for UK investors.

With investment in commodities through these vehicles, corporate factors unrelated to commodities may affect the investment outcome, which will not be identical to that derived from investing in commodities directly.

Let us look at hard and soft commodities, and the various types in each category.

The range of commodities – hard

Hard commodities, the product of extractive processes, include energy and metals.

Energy

Energy is the largest market in commodity derivatives, covering electricity and gas contracts in the OTC derivatives market. The energy market has grown in recent years, partly because of the deregulation of electricity generation in the United States and Europe, and trading has expanded in an increasing range of energy-related financial instruments. Investment banks and hedge funds are now active in the market, as well as oil and gas producers and consumers.

Some countries want to reduce their dependence on crude oil, but there is a lack of cost-effective substitutes. There are fears that there is not enough cheap oil left in the world. Experts do not agree on the true resources of oil-producing nations, and there is enormous volatility in oil prices.

Between September 2003 and July 2008, the inflation-adjusted price of a barrel of crude oil rose from under US\$25 to US\$147.50 a barrel, largely as a result of a perceived global shortage of oil, based not least on reports from the US Department of Energy and elsewhere showing a decline in petroleum reserves. Middle East tension helped to drive the oil price up, and speculators played a major part. The global recession then caused demand for energy to fall, and oil prices fell sharply, although at the time of writing it has recovered some of its position.

Natural gas, seen as environmentally superior, becomes attractive when oil is priced too highly. Russia is the world's largest natural gas producer, but is seen as an unreliable supplier with its lack of investment in the industry and the reach of the Kremlin's political agenda.

ICE Futures is Europe's leading futures and options exchange for energy products, with nearly three-quarters of its worldwide business in Brent Crude. The exchange also trades gas, oil and, from February 2006, West Texas Intermediate crude contracts.

Non-ferrous metals

The LME is the world's leading non-ferrous metals market, with more than 95 per cent of its business coming from overseas. It is a Recognised Investment Exchange, regulated by the Financial Services Authority (FSA), which also oversees the conduct of LME member firms. Following the Sumitomo copper trading scandal in 1996, where a rogue trader unsuccessfully tried to corner the world copper market by buying up copper to boost its price, the LME radically restructured its approach to regulation and compliance to prevent any future manipulation of the market. The Exchange introduced lending guidance requiring the holders of dominant positions to lend back to the market at agreed rates, ensuring that trading remained orderly.

The LME's three core services are hedging, pricing and physical delivery. The Exchange provides futures and options contracts for a range of base metals such as aluminium, copper, nickel, tin and zinc as well as plastics and steel billet. From 2010, it was to provide new futures contracts for molybdenum and cobalt – so-called 'minor' metals. These various contracts enable the physical industry to hedge against movements in the price of raw material.

Of the six metals traded, the Exchange's largest contract is for primary aluminium, extended in September 2008 from 5 to 10 years, giving users longer access to the contract. The second largest contract is for copper (Grade A), which has applications in housing, construction and many other areas of activity and was similarly extended. In recent years, there has been an increased demand for copper from China, India and other developing nations. Chile and the United States are the major producers.

The other contracts traded on the LME are zinc, tin, lead and nickel, plus two aluminium alloy contracts. High-grade zinc, primary nickel and standard lead contracts have been extended to five years. There is also a metals index future. Futures contracts can be traded any day from cash (two days forward) to three months ahead; they can then be traded weekly, followed by monthly.

In December 2006, the Exchange launched 'LMEmini' contracts for copper, aluminium and zinc. LMEminis are smaller than standard contracts, in five-tonne lot sizes, cash-settled and traded electronically and via the telephone.

The LME offers eight plastics futures contracts for polypropylene and linear low-density polyethylene. The plastics industry has suffered intense price volatility over recent years, which is starting to become unmanageable for many

parts of the supply chain, according to the LME. It says that the emergence of new world economies, such as China, and their demand for industrial raw materials, is changing the global balance of supply and demand. Plastics futures are a way to manage risk through hedging, and so a way of addressing the problem of price volatility.

The LME has launched two regional (Mediterranean and Far East), physically delivered, steel billet futures contracts, which it says are the start of a long-term plan to bring price risk management to the steel industry. The entire billet market is around 812 million metric tonnes annually.

Trading on the LME is conducted in lots rather than tonnes. Each lot of aluminium, copper, lead and zinc is 25 tonnes, but nickel is traded in 6-tonne lots. In 2006, the LME saw trading volumes rise almost 10 times on the 1988 level, to over 78 million lots traded. In 2007, this reached 93 million lots traded, the equivalent to US\$9.5 trillion annually, while in 2008 total trading volumes surpassed 113 million lots with a total notional value of \$10.2 trillion. LME prices are quoted in dollars per metric tonne, but can be cleared in sterling, euros or yen.

Three trading platforms are in use at the LME: open outcry, telephone-based or electronic systems, with different levels of membership and access. Only the 12 ring-dealing members (category 1) are able to trade by open outcry on the 'ring', a market open from 11.45 am to 5.00 pm and the process that sets the official physical prices in metals and plastics for the day. Recently, ED&F Man, a large commodity-trading house, became the first new member of the ring in a decade. Even in this era of electronic trading, the ring remains the focal point of price discovery at the LME.

Category 2 members typically include large financial institutions such as HSBC and UBS. They may trade by telephone, which is a 24-hours-a-day market, or electronically via LME Select, open from 1.00 am to 7.00 pm. A metals company wanting to hedge selects a member firm on the basis of the level of trading and access to the market it requires, as well as its business model and internal processes.

The LME contracts are highly liquid and are usually settled financially, but if required, they are backed by ultimate delivery of the underlying metal or plastic. To facilitate this, the LME has more than 400 approved warehouses.

In March 2007, cleared average price swaps were introduced on the LME. These allow OTC member-to-member contracts for category 1 and 2 members to be cleared on the Exchange. It is a step towards linking the OTC and the exchange-traded products.

Developments in 2008 included the launch of LMElive, a real-time data feed that gives customers price information direct from the Exchange.

Precious metals

Precious metals, unlike non-ferrous metals, are often owned physically. They are traded away from the LME. The most prominent of the precious metals is gold.

Gold and silver

Gold is a basic store of value against inflation, depreciating currencies, revolution and war. It differs from other metals in that it does not have industrial uses. It is mainly bought for jewellery, and its volatility has proved limited compared with that of most commodities. If the dollar weakens, gold, as a dollar-denominated currency, grows in demand, although it becomes more expensive for buyers holding other currencies.

London has had a market in gold for centuries; since 1717 there has been a de facto gold standard, and from 1816, there was a legal gold standard. From 1934, the United States adopted a gold exchange standard, requiring it to buy gold at US\$35 an ounce. In the 1960s, a consortium of central banks was dealing in gold through London in attempts to curb speculative price movements. It did not always work. In 1968, central banks replaced this intervention with a dual system of central bank dealing, to maintain the US gold price, and free market dealing. In 1971, the United States devalued the dollar and ceased its link with gold.

The majority of global gold trading is through OTC transactions, which are flexible and subject to the agreement struck between the counterparties, although there are also standardised exchange-traded futures and options, including through London terminals of the COMEX division of the New York Mercantile Exchange.

London is the main centre for the 24-hours-a-day OTC market, and the lowest transaction size is typically 1,000 ounces. Most OTC trades are cleared through London, and most major bullion dealers around the world are members or associate members of the London Bullion Market Association. Trading is done by telephone and electronically. The market is most liquid in the London afternoon, which is when it is morning in New York and both markets are open.

The reference price for the day's trading is a 'fix', which is done twice a day during London trading hours. There is a bidding process in which the gold price adjusts until orders are all matched and the price is fixed. From 5 May 2004, gold price fixing ceased to take place at NM Rothschild and instead started to be conducted daily by telephone at 10.30 am and 3.00 pm, London time. There are five gold price-fixing members: the Bank of Nova Scotia-ScotiaMocatta, Barclays Bank, Deutsche Bank, HSBC Bank USA and

Société Générale. The chairmanship of gold price fixing rotates annually among its members.

The basis of settlement is delivery of a standard London Good Delivery Bar. The clearing process is a system of paper transfers, avoiding the security risk and cost of physical movement.

The gold price quoted in the international market is the spot price – for delivery during the two days after the transaction date – in US dollars per troy ounce.

Other forms of transactions in gold, notably forwards, futures and options, will be settled against a date further in the future than the spot settlement date. The forward or futures price is a function of the underlying spot price and the prevailing interest rate in the money markets plus insurance and storage.

The forward premium will usually be quoted as a percentage of the underlying price. Gold is nearly always in a contango, meaning at a premium over the nearby price, because of the ready availability of above-ground stocks, which can be borrowed at low interest rates. A backwardation may happen during a price squeeze, but is extremely rare.

Gold has no credit risk because it has no counterparty, which makes it attractive to investors in times of financial stability, according to International Financial Services London (IFSL), which has noticed some level of inverse relationship between gold prices and other investment returns, such as on shares. In 2008, the gold price was on average up 28 per cent on the previous year, which the IFSL attributed partly to its ‘safe haven’ appeal in the credit crisis, but also to such factors as rising industry supply costs, high commodity prices and central bank easing. Gold closed that year at US\$870 per ounce, after having edged back from an all-time high of US\$1,011 per ounce in March 2008, partly because of a strong dollar and deleveraging by short-term investors.

Silver

Silver is a more practical metal than gold, but is similarly a store of value. The metal has been used as money for longer than gold, and in more countries. It is used in, among other areas, technology, photography and electronics, as well as in jewellery and silverware, and industrial demand is rising. It is the best conductor of metals, although copper is preferred for this because it is cheaper.

The metal is in demand from investors, including hedge funds, and through the iShares Silver Exchange Traded Fund, which was started in April 2006.

Silver reached over US\$20 per ounce during 2008, a level not reached since the 1980s, and its average price was up 12 per cent on the previous year.

Platinum

Platinum comes mostly from South Africa. It is used in industry, and to a lesser extent in making jewellery. It is a rare metal, but supply is at least equal to demand. It has attracted speculative traders, including a few hedge funds, and is volatile.

Palladium

Palladium is derived from nickel mining in Russia and Canada, and is also produced in South Africa. It is found in the same ores as platinum, but is less useful in some machinery, including diesel engines. It is half the weight of platinum, so is used to make lighter jewellery. The metal has attracted trading from hedge funds. Unlike for gold, there are no significant above-ground stocks in palladium, which means supply can run scarce, driving up demand.

The range of commodities – soft

Manufacturers use soft commodity futures to ensure that farmers deliver raw materials, such as sugar or wheat, at a fixed price when required. Farmers also use futures.

Soft commodities are affected by climate issues, and factors such as drought and frost. They are also affected by politics, particularly in the case of cocoa and coffee, which are often grown in politically unstable countries. As with hard commodities, the price benefits from strong demand from China and elsewhere. The price in the developed world tends to be inelastic, which means that price fluctuations make little difference to demand.

On NYSE Liffe, the London-based international derivatives arm of NYSE Euronext, the markets in soft commodities are much smaller than those in crude oil futures. But cocoa, Robusta coffee and white sugar futures on the exchange set the global price benchmarking for the underlying physical markets, and are actively traded by managed funds, other institutional investors and a range of short-term investors. The products are also traded on the Coffee, Sugar and Cocoa Exchange (CSCE) in New York, owned by the New York Board of Trade, in contracts sometimes strongly correlated to NYSE Liffe, which provides arbitrage opportunities. Coffee, sugar and cocoa are not the only soft commodities, but are widely traded. Let us take a look at each.

Coffee

Coffee is produced by over 40 countries, and there are two main types. There is Arabica, which is the most widely produced, and Robusta, which is the stronger.

Coffee commodities are traded in a free market by speculators as well as coffee growers and exporters, and the United States is the largest consumer.

NYSE Liffe has a Robusta coffee contract, and the New York Board of Trade has an Arabica coffee contract.

Sugar

Sugar is produced in 110 countries, and about a third of it is exported. NYSE Liffe operates the main white sugar futures market and the New York Board of Trade operates the main international raw sugar futures contract as well as a domestic one.

Demand for sugar is strong, partly because of its use as fuel to power converted cars. Supply is shrinking, partly because of a curtailment in European subsidies.

Cocoa

Cocoa is grown in Africa, Asia, Brazil and the Caribbean, and production depends partly on weather and prices, and the growing policies of countries. A cocoa tree takes seven years to grow, and each cocoa fruit on the tree has around 40 beans.

Over 80 per cent of the world's production is now deliverable against the NYSE Liffe contract.

Bclear and commodities

For those who want to do business away from the central market, meaning OTC, but also want central clearing and processing, NYSE Liffe offers its Bclear service. This was launched initially for OTC equity derivatives, but it now covers commodity contracts as well. Commodities on Bclear, at the time of writing, encompass cash-settled swaps and cash-settled European-style options in cocoa, Robusta coffee and white sugar. The Exchange is planning to increase the range of commodity products and derivative instrument types.

Deals, once agreed, can be submitted to Bclear for clearing. NYSE Liffe Clearing, NYSE Liffe's clearing house, becomes the central counterparty to all transactions between clearing members, so significantly reducing the counterparty risk involved in bilateral OTC deals.

The investment case for commodities

Commodities carry a perception of high risk, partly because of their volatility, but also because commodity derivatives are typically traded on margin.

One argument for investing in commodities is that it adds an element of diversification to a portfolio. A 2006 paper by Gorton and Rouwenhorst shows that between 1959 and 2004, a portfolio of 34 commodities made returns negatively correlated with stocks and bonds, suggesting that commodities are an ideal form of diversification.

Another case for commodities is that they give high returns, but this is more controversial. There is no dispute that commodities are driven by supply and demand, and that when these are out of kilter, investors can make a profit. However, the commodities portfolio scrutinised in the Gorton and Rouwenhorst paper generated an average return and volatility compared with stocks.

Over a shorter, more recent period of years before the credit crunch, it was commodities that had overpowered stocks. Commodities expert Jim Rogers points out in his book *Hot Commodities* (2007: 27) that the Rogers International Commodities Index, which he founded, was up 254 per cent eight years after its start on 1 August 1998, while the Standard & Poor's index of major US stocks was up 32 per cent. He noted that commodities had outperformed bonds over the period, and that the Lehman Long Treasury Bond Index was up only 67 per cent.

Rogers generally puts the case that China is becoming economically strong and that its 1.3 billion population is the major source of high demand for commodities. The counter-argument is that much of China's growth reflects a shift in manufacturing location from the West to China, most Chinese people are very poor, and that China will increase its own production of commodities, following which it will negotiate lower prices when it imports commodities from abroad.

The other case for a boom in commodities – less fashionable at this time – is that they are supply-led. One indication of a shortage of supply has been decreasing LME stocks in some metals. Energy and metal prices rise when the currency is weak and fall when it is strong, although often with a lagged effect. Soft metals are unaffected by the greenback.

Regulation

The Markets in Financial Instruments Directive (MiFID), implemented from 1 November 2007 (see Chapter 23), introduced for the first time a legislative regime for some firms trading commodity derivatives.

The FSA has taken the view that bringing commodity and exotic derivative contracts within MiFID's scope was justified in principle, but the case for regulating certain specialist commodity derivatives firms, and the appropriate regulatory regime for them, needed clarifying. There had been some compromise, with MiFID exemptions removing some specialist firms from the scope and some carve-out on capital requirements.

Foreign exchange

Introduction

London has the largest foreign exchange market in the world. In this chapter, we shall look at how it works, including main currencies and transaction types, and its participants.

Global overview

Foreign exchange is the most liquid of the financial markets in the City, and the largest. In 1979 exchange controls were abolished, which made it easier for companies to export money. By this stage, there were many dealers working in banks, and the infrastructure was in place for foreign exchange trading. The foreign market in London expanded.

This is an international market where currencies are transferred and exchanged quickly and exchange rates fluctuate rapidly. Foreign exchange has no central exchange or main physical location, but business is conducted from financial market centres around the world. The market is 24-hour, with trading most active at points in time zones where trading times overlap. A trader who has bought into a currency will often invest the amount in high-interest-paying liquid securities, which means foreign exchange has a knock-on effect on other markets.

The market is historically driven mainly by speculative flows. Some estimates suggest that as much as 95 per cent of foreign exchange trading is speculative (Maslakovic, 2009b: 6). The next main driver of the foreign exchange market is trading from governments, central banks and companies. Foreign exchange, like derivatives, is used for hedging, and leverage in this market can be very high, with the funds needed to open a position sometimes

reflecting only 1–2 per cent of the opened position. Trading activity determines the exchange rate, which is the amount of one currency that buys a unit of another currency.

Currencies

Trades involve buying one currency and selling another, and there is a potential for profit so long as exchange rates move. There are 170 currencies in use worldwide, but most are not very liquid. The US dollar is by far the most widely traded currency, not least because the United States has the biggest and most liquid bond markets, and commodities are priced in dollars.

The US dollar is the global reserve currency and an invoice currency in many contracts. Many believe that, in a few years' time, the dollar will no longer have this status. So far, there has been fluctuation, but the contrary has happened. As the 2007–10 financial crisis worsened in the third quarter of 2008, there was a flight to the dollar, which regained some of the strength it had lost earlier against the pound and the euro. The yen and other low-yielding currencies were similarly perceived as a safe haven, and they gained from the crisis.

The euro, introduced at the start of 1999, initially in non-physical form, has enabled eurozone member countries to trade with each other directly without the need to exchange their currencies. The euro enabled London to increase its share of foreign exchange markets because transactions in sterling no longer had to compete with those in a variety of European currencies.

Other important currencies for trading purposes are the Swiss franc, sterling and the yen, and then the Australian dollar. Next are currencies such as the New Zealand dollar and the Norwegian krone, followed by those of emerging markets, and the less popular currencies such as those in Arab countries.

Oversight and intervention

The foreign exchange market is unregulated, but the Bank of England oversees it. It may intervene in it, either openly or through an intermediary, when the government or a financial authority wishes to influence exchange rates.

UK market share

According to the IFSL Research Foreign Exchange 2009 report, published in September 2009 (Maslakovic, 2009b), the United Kingdom is the main geographic centre for foreign exchange trading, with the United States a long way behind as the second largest centre.

The historical data shows the United Kingdom slightly gaining in market share in recent years and the United States slightly declining. In 2004, the

United Kingdom had a 32 per cent global market share of foreign exchange trading, which reached 35 per cent three years later in 2007 and 37 per cent in 2008, slipping to 36 per cent in 2009. In comparison, the US market share was 18 per cent in 2004, dropping to 17 per cent in 2007 and to 14 per cent in 2008, with a further decline to just under 14 per cent in 2009.

Globally, according to the IFSL report, the foreign exchange market nearly doubled between April 2005 and April 2008, benefiting from increasing hedge fund and retail investor participation, and from a proliferation of trading platforms, which have made it easier to access this market.

Foreign exchange trading volume soared as the credit crunch started in 2007. According to the IFSL report, rate cutting from central banks had caused a flight from emerging market to safe-haven currencies, and foreign exchange was 'one of the few sources of steady profits for banks'. Global bank revenues from foreign exchange trading gained not just from increased trading volumes, but also from higher commissions, given the broadening of foreign exchange spreads.

As the IFSL has reported, in April 2009, average daily turnover on the UK's foreign exchange market was US\$1,269 billion, with a further US\$81 billion traded in currency derivatives. Trading had fallen by a quarter in the preceding year, bringing it back to pre-financial crisis levels. Most of the global foreign exchange trading is in London, where it gains from the large hedge fund community and prime brokerage services located in London, as well as the significant amount of European banking activity.

The participants

Dealers

The dealers are traders in the large commercial banks, which run day and night shifts. They operate like dealers in the money markets, OTC derivatives and bonds. They buy and sell currencies for clients, quoting competitive real-time spreads on portals, which are online markets. They may hedge this exposure, and will take speculative positions for themselves.

A dealer of one bank will deal directly with those in the trading room of another. Dealers make money from the spread, which is the difference between the buy and sell price.

These banks are the sell side, making a market in foreign exchange or enabling client business, and their customers make up the buy side.

The banks have access to the primary markets, which heavily influences prices in secondary markets. The 10 largest banks account for most of the

turnover in London's FX market, and the smaller banks trade with them rather than with each other. According to the Euromoney FX survey, Deutsche Bank was the largest foreign exchange dealer in May 2008, with a 22 per cent share of overall volume, followed by UBS AG with a 16 per cent share, and Barclays Capital with 9 per cent.

According to the IFSL report, inter-dealer trading generated 34 per cent of foreign exchange activity in April 2009, which has declined nearly two-thirds from 10 years earlier because technological advances have reduced the need for intermediaries. Trading volume is high because one customer transaction often leads to further transactions, as banks readjust their own positions to hedge or manage the new levels of risk.

Brokers

Direct dealing, without a broker, is out of fashion. As in the money markets, dealers may use a voice broker, who operates as a go-between to broke foreign exchange, but this method has been increasingly giving way to electronic inter-bank broking platforms.

Now the majority of global foreign exchange trading takes place electronically, which has made the market more efficient and transparent. Traders can obtain prices from one portal without needing to check other sources, and retail traders have the same access. As a result of this shift to electronic trading, supply and demand no longer entirely dictate exchange rates. There is a perceived 'liquidity mirage' by which some large banks promise at any time to trade a given amount of currency at a given price. The concern is that this could be putting them in the position of holding what they cannot sell.

Investors

According to the IFSL, foreign exchange has developed as an asset class over the past decade, partly because it is uncorrelated to any other asset class.

Investment funds do most of the foreign exchange business, and they invest real money. The fund manager may manage foreign exchange risk through a currency overlay programme, which hedges currency exposure from overseas investments, or aims to generate returns for assuming extra risk, known as Alpha.

On anecdotal evidence, the hedge funds have done up to half of all foreign exchange trading, but the 2007–10 financial crisis may have had some impact on these levels. Hedge funds engage in high-frequency trading and include foreign exchange in a basket of asset classes for synthetic arbitrage purposes, making money out of a statistical likelihood.

Commonly, hedge funds operate as the buy side in posting their own prices and, in some cases, are effectively making a market. In such a way, the dividing line between the buy and sell side is blurring. The hedge funds can drive a currency further up or down than it would otherwise go, which can send the foreign exchange market into chaos. The classic example was in September 1992, when hedge fund entrepreneur George Soros initiated his most famous transaction. His hedge fund vehicle, the Quantum Fund, took a US\$10 billion short position in sterling on a bet that it was overvalued. The British government raised interest rates to prop up the currency, but Soros reacted by increasing his position. The Bank of England eventually withdrew the pound from the European Exchange Rate Mechanism (ERM), and sterling plummeted. Soros made an estimated US\$1 billion.

Away from funds, the central banks are major customers in the foreign exchange market, trading their reserves through the 'reserves adjustment' process. They have access to significant foreign exchange reserves. Central banks may sell their reserves in a foreign currency to support their own. They regularly adjust their massive US dollar reserves, and so become significant buyers and sellers of sterling, the yen and euros, as well as dollars. They can trade anonymously through the Bank for International Settlements (BIS), which serves as a bank for central banks. China particularly has increased its foreign exchange reserves in recent years, and according to Wikipedia/IMF figures, in June 2009 it held a market-leading 28 per cent share by country and currency of the world's total of US\$7,500 billion.

Sometimes, central banks work together internationally to keep exchange rates at an agreed level, but this practice is less common than it was. Open intervention by central banks can fail, as the Bank of England found when faced with Soros's bet.

Companies are also significant players in foreign exchange, although their participation has dwindled compared with the capital flows of speculators. A company can hedge against the risk of such currency fluctuations. When, for example, a company knows that it will receive a large US Treasury coupon payment in November, and takes the view that the dollar will go lower before then, it may then, for instance, take a short position in dollars using the options market. A company may also speculate on foreign currencies for profit.

Companies have not always dabbled in foreign exchange wisely or prudently. In the 1980s, Japanese companies were involved in a scandal where they traded more in currencies than was justified by their business. Disgraced US energy company Enron did a lot of foreign exchange business.

Retail traders can deal through retail foreign exchange platforms, but have sometimes been treated unfairly this way.

Exchange rates

Traders focus on the exchange rate. Currencies may be expressed against the dollar, but sterling is the exception and people talk of dollars to the pound. According to IFSL estimates, the US dollar/euro was the most widely traded currency pair in April 2009, with 28 per cent of overall turnover. The US dollar/yen came next, with 18 per cent of turnover, followed by the US dollar/pound sterling at 11 per cent. Emerging market currencies accounted for about 18 per cent of turnover, a share that has grown in recent years due to the high gain potential, although it has involved higher risks.

In recent years cross-rates, where the US dollar is not included as one of the currencies, have gained in significance. Cross-trades in liquid currencies take place without reference to the US dollar exchange rate.

Supply and demand

When a currency is not fixed against another, the price is driven by supply and demand, with demand sometimes related to transactions.

To exercise some control, central banks can adjust the money supply. The higher the interest rate of a country, the more its currency is in demand from speculators. However, as Soros's bet against the Bank of England showed, selling on a large enough scale can counteract interest rate rises.

At the time of writing, China, Japan and some other Asian countries have an exchange rate that is formally or otherwise fixed against the US dollar, which gives them an international trading advantage over countries with floating rates such as the United Kingdom.

Transaction types

When a company trades overseas, it must agree with its trading partner not only which currency should be used, but also whether delivery should be immediate, which is spot, or subsequent, which involves derivatives. Let us look at each.

Spot market

The spot transaction is the most common type of currency transaction. Two currencies are exchanged at once, using an exchange rate agreed on the day. Dealers quote spot rates as a single unit of the base currency against some units of the variable currency.

There is a different rate for buying the currency than for selling it. The difference is the spread, which is the market maker's gross profit, and it varies

depending on the customer's or counterparty's status and the currency's liquidity. The transaction, with some exceptions, takes two working days for cash settlement, known as T+2.

The spot market is not always liquid, although liquidity may be boosted by automated trading. When there is high volatility, but few trades, market makers have been known to remove their quotes because they cannot hedge their exposure.

Derivatives

There are a variety of currency derivatives, and they are traded on the over-the-counter (OTC) market.

Forwards

Forward contracts in currencies enable the sale of a stated amount of currency at a specified exchange rate and on a specified future date or within a given time period. If you will need dollars in six months, you can buy them now in the forward market.

For example, a UK exporter to the United States may be about to complete a business transaction in another country, but they do not know in which direction the exchange rate will move over the next three months, or how far. They can complete the transaction and then protect themselves from the currency exposure. To do this, they would sell the dollars received forward and, after three months, receive a fixed sterling price for them.

The bank would take the dollars from the exporter at the three-month forward rate. Because it would be due to repay these dollars after three months, the price that it would charge now, the spot rate, would have to cover its own risk. According to the theory of interest rate parity, the difference between the spot rate and the forward rate equals the interest rate differential between the two countries over the period. The bank will usually cover its risk by a foreign exchange swap.

Futures

Currency futures are traded in multiples of fixed-size lots, and delivery dates are standardised. The Exchange is the counterparty to transactions, which effectively removes counterparty credit risk, and traders must put up margins that, if required, they will maintain in order to keep their position covered.

Options

We have seen how options work in Chapters 8 and 9, and these can be applied to currencies. Besides straightforward (or 'vanilla') currency options, there are

exotic options, which may be used, among other purposes, to trade against the volatility of volatility.

Among the exotica are barrier options, where banks ‘knock’ deals in and out at various levels to make them more marketable to clients. Let us take a hypothetical example. If there were €1.20 to the US dollar, and a client of a bank was to buy the right to buy euros at €1.25 to the dollar in six months’ time, the cost could be 2 per cent of an underlying €1 billion, which the client could say was too expensive. The bank may instead sell a €1.25 call option for three months, but to make it cheap, knock it out at €1.28, which would mean that the client would lose everything if the currency reached this level. Let us say that the client only made real money at €1.25. The return would increase up to €1.28, at which point the client would lose all to the bank.

Barrier options are now traded in their own right, and volatility arising from such trading has often surpassed movements in the underlying currency, although affecting it. Channel trading demonstrates how, for example, the euro/US dollar variations, influenced by options trading, move within a narrow range, and then jump out of it into another. Instead of a zigzag on the graph, there is a zig, a straight line, and then a zag.

Each of the barrier trade positions will be hedged or dealt against by both sides of the transaction, which multiplies the turnover of the options markets.

Swaps

In a currency swap, a company may raise an amount in the currency that it can borrow in most cheaply, and swap the proceeds with the equivalent amount in a target currency. After interest rate swaps, this is the most common type of swap.

The numbers

In its Foreign Exchange 2009 report, the IFSL has provided a breakdown of the types of instruments used in global foreign exchange trading in April 2009. Of the total turnover, spot transactions were 38 per cent, up from 31 per cent a year earlier. Outright forwards were 12 per cent, up from 11 per cent, and foreign exchange swaps were 45 per cent, down from 53 per cent. OTC currency swaps and options accounted for 6 per cent of turnover, and exchange traded contracts 2 per cent.

An analyst's perspective

Chris Furness, head of currency strategy at 4CAST, a market analysis company, has information feeding into him from three sources: fundamental, technical and market analysis. Fundamental analysis covers how exchange rates reflect interest rates, inflation, speculative capital flows and economic factors.

According to Furness, figures from the United States are the most important, followed by those from the eurozone, including those from individual countries within it. Japanese and Swiss currency data are sometimes important because of interest rate movements within those countries, which affect interest rate differentials.

He says that the most important figure two to three decades ago was the US money supply, but it is now the monthly non-farm payroll numbers, which show US employment data. Price data is currently significant and he also looks at the US trade figures. If there is a record trade deficit, the dollar will come under pressure, and if it falls other currencies will rise, with bigger reactions seen when expectations are exceeded in either direction.

Expectations about inflation influence interest rate expectations rather than the other way round, Furness says. 'If there is talk of raising US interest rates, the minutes of a previous Federal Reserve Bank meeting could become important.'

He believes that technical analysis (see Chapter 20) can become a self-fulfilling prophecy in foreign exchange because of the huge numbers of users in the marketplace. Such analysis has become indispensable in timing transactions.

Purchasing power parity (PPP) is the concept that exchange rates will converge to a level at which purchasing power is the same internationally, so countering inflation. It is the oldest theory of how exchange rates are formed, but according to Furness, it rarely works in the short term.

Economists say that an imbalance between exchange rates and inflation is driven by speculative capital flows seeking to make money from currency differentials and can last a while, but PPP works better over the long term. Governments take PPP seriously in the quest to keep their currencies stable.

Default risk

Default risk arises in foreign exchange, and any party to a transaction needs to exercise due diligence in checking out its counterparty. There are settlement and pre-settlement risks.

In the past, settlement risk has been greater than now. It was a manual process, using paper transactions, which was both expensive and left scope for errors. Settlement risk arose because one party paid out before the other.

Straight-through processing has gone a long way towards a solution that cuts costs and errors. It has replaced manual and paper-based processing, and the journey from trade inception to settlement is electronic, which is appropriate for the automated trading in this market.

The Society for Worldwide Interbank Financial Telecommunication (SWIFT) has provided the foreign exchange market with connectivity and standards through its electronic network. Continuous Linked Settlement (CLS) provides a payment-versus-payment model, enabling both sides of a foreign exchange trade to settle simultaneously.

In general, netting, by which two parties offset trades, making it necessary to pay out only net amounts, has greatly reduced risk. The risk here is that if one of the parties defaults, a liquidator could challenge the netting agreement, leaving the non-defaulting party having to join a queue of creditors in claiming for losses.

There may be a requirement to put up collateral, otherwise known as margin, for trades, particularly the large ones. As we have seen, traders will add to their margin where necessary to cover their open positions.

Some credit risk remains, particularly pre-settlement, and participants in foreign exchange markets must have reciprocal credit agreements in place, with limits based on the counterparty's credit risk.

Further research

To find out more, I recommend visiting the website of inter-dealer broker ICAP (www.icap.com), and registering online with the ICAP Knowledge Centre, where you will have access to some excellent free courses on foreign exchange.

The London Stock Exchange and its trading systems

Introduction

There are three tiers in the equity capital market infrastructure today: trading, clearing and settlement. They are integrated, but each performs a different function. In this chapter, we shall look at equities trading at the London Stock Exchange (LSE). Read this in conjunction with Chapters 16 and 17.

Overview

A stock exchange performs various functions, including the launching of new securities issues and the dissemination of information. On the secondary market, its main role is to bring together buyers and sellers through a centralised trading system.

The LSE evolved from an informal market trading government debt from the late 17th century. In the early 19th century, the Exchange introduced a governance structure.

In the following decades, the LSE expanded with increasing interest in foreign mining shares and railroad securities. Members of the LSE paid fees and new members were eventually required to become shareholders. The LSE suspended trading in July 1914 until the start of 1915, in line with other European exchanges. In 1918, the British government introduced a series of 'Victory bonds', a successful savings bond used to help fund the war effort, and trading on the LSE became busy again.

Equities and more



At the London Stock Exchange we offer equities and more. In fact we offer listing, trading and market data services across equities, corporate and government bonds, ETFs and other exchange-traded products, as well as futures and options through our derivatives business, EDX London.

To take a fresh look at what we can offer visit www.londonstockexchange.com



London
Stock Exchange

Introduction

The London Stock Exchange is the world's most international exchange with over 600 overseas companies from more than 70 countries quoted on its markets. Companies from around the world come to our markets to raise money for growth, gaining access to one of the world's deepest and most liquid pools of low cost capital.

The Exchange offers equities and more; facilitating trading in additional products such as Exchange Traded Funds, Exchange Traded Commodities, derivatives and fixed income. Recently it launched a new retail bond market providing private investors access to a transparent and efficient marketplace for UK corporate and government bonds.

Information is the lifeblood of efficient markets. Derived directly from its markets, the Exchange provides broad and rich sets of data - published in real time, enabling traders, fund managers and brokers among others to make decisions with confidence and run their business effectively.

In addition the London Stock Exchange incorporates several businesses including: EDX London; facilitating trading in Scandinavian and Russian equity derivatives; Proquote; a leading cost effective global market data provider sourcing data from over 160 markets, news and data sources throughout the trading day and RNS; the longest established Regulatory Information Service in the UK and one through which companies quoted on the UK Listing Authority's Official List or traded on AIM release information of interest to the market.

Specialist securities

The London Stock Exchange offers a wide range of specialist securities, such as Exchange Traded Products and covered warrants, which allow investors to trade and invest in products that suit their own portfolio and strategies. All such products can be traded through stockbrokers that are member firms of the London Stock Exchange; they are admitted to the Regulated Market, ensuring the issuers and securities are subject to a high standard of regulatory oversight.

Exchange Traded Products, such as Exchange Traded Funds and Exchange Traded Commodities, allow investors to access a wide range of underlying instruments from whole indices like the FTSE 100 to single commodities such as gold. Such exposure is traditionally hard to achieve with a small investment, but Exchange Traded Products allow investors with any size of investment to gain exposure to their choice of underlying at low cost. Liquidity is provided by market makers throughout the trading day, ensuring easy access to transparent price information.

Covered warrants are listed securities issued by financial institutions which give holders the right, but not the obligation, to buy or sell an underlying asset at a

specified price, on or before a predetermined date. Developed for the private investor, covered warrants can be used for hedging, speculative or geared trading strategies and unlike traded options do not require margin accounts or margin calls to gain leveraged exposure.

Bonds for private investors

Providing private investors with the opportunity to diversify their investment portfolios to include fixed interest securities, the London Stock Exchange launched an electronic bond trading service in early 2010, giving private investors access to a transparent and efficient marketplace for UK government and corporate bonds. The market model is based on Europe's most heavily traded private investor bond market – Borsa Italiana's "MOT" market, which itself is a part of the London Stock Exchange Group.

The UK service facilitates electronic trading in bonds issued in retail-size denominations - for example investors are able to trade most corporate bonds in units of £1000. The Order book for Retail Bonds trading service also provides an alternative means for issuers to raise capital by issuing bonds directly to the private investor community through the platform - providing a diverse and direct source of finance for corporations.

EDX- the driving force for derivatives

EDX London, a subsidiary of the London Stock Exchange and a Recognised Investment Exchange in its own right, provides futures and options trading in a range of international markets across equity, index and fixed income asset classes.

To date key markets offered by EDX include Scandinavia and Russia. In 2006, EDX London launched its award winning trading and clearing service for Russian derivatives on individual and index depositary receipts (DRs) traded on the London Stock Exchange. EDX London now trades the majority of Russian equity DR options globally.

EDX London collaborates with Oslo Børs to offer their respective members access to each other's markets, order books and liquidity. Members can access each Exchange's products using their local membership and clearing arrangements. All trading is cleared through LCH.Clearnet using clearing technology supplied by London Stock Exchange Group's post trade services division.

In March 2009 TMX Group (Toronto and Montreal Exchanges) and London Stock Exchange Group announced a strategic partnership focused on building a new derivatives joint venture. [This included TMX acquiring a 20 per cent stake in EDX and the adaptation of TMX's SOLA trading platform for EDX and

Oslo Bors]. There are plans to further develop the partnership on an international scale.

Proquote - global market data provider

Proquote, a fully-owned subsidiary of the London Stock Exchange is a global market data provider offering cost effective access to over 160 markets, news and data sources throughout the trading day.

An intuitive terminal, Proquote's extensive coverage includes information on equities, fixed income, futures, options, commodities, metals as well as OTC pricing. It also features comprehensive data on company fundamentals and a suite of charting and analytical tools for scenario simulations and decision making support.

It offers a wide range of trading services through its trading platform and FIX execution gateway. The Proquote Order Management System (OMS) offers brokers the ability to place orders directly on the London Stock Exchange order books or route orders to any of the Retail Service Providers on the Proquote network.

Additionally Proquote provides a suite of powerful pre and post trade execution monitoring and analysis tools showing a historical consolidated view across all European exchanges enabling best execution to be determined.

Regulatory News Service (RNS)

RNS is the provider of choice for major financial PR agencies and corporate advisers along with the vast majority of the UK's listed and quoted companies. Companies choose RNS for its track record of service excellence, reliability and commitment to continuous improvement.

RNS is the UK's leading financial and corporate news distributor. It is widely recognised for its security, market awareness, industry knowledge, product flexibility and 24 x 7 support structure. Companies, their advisers and market participants use RNS to meet disclosure obligations including:

- the UK Listing Authority's Disclosure and Transparency Rules
- AIM Rules for companies
- Takeover Panel's (POTAM) Disclosure Rules

Releasing announcements using RNS's global channels ensures information is distributed immediately and accurately on key vendor terminals such as Thomson Reuters, Bloomberg, Dow Jones as well as our own website. RNS distributes a wide range of regulatory and non-regulatory announcements in full text to over 2 million market professional terminals and financial websites across the world.

In the Second World War period, the Exchange helped the Treasury to market Treasury issues. Committees of LSE proprietors and members were combined into a council, dominated by members, and the government took effective control. In 1948, dual control by proprietors and members ended. In 1974, the LSE merged with domestic exchanges across the United Kingdom. The International Stock Exchange, as it became known, was bigger and could regulate the securities industry better, but was less able to fend off foreign competition.

In 1979, Margaret Thatcher's government abolished exchange controls, which meant that financial institutions could invest abroad easily. Big Bang, the deregulation of the London stock market on 27 October 1986, was part of a broader move by the Thatcher government to reduce the influence of the LSE as a private club that controlled its members according to its own rules, and to stop capital flight from London. Overseas securities firms could, for the first time, become members of the LSE. Trading on the floor of the LSE was replaced by a screen- and telephone-based system. Fixed stockbroking commissions and single capacity were abolished. The jobber who had quoted wholesale share prices to the stockbroker on the trading floor gave way to market making.

The Big Bang strengthened London's competitive position globally, but according to some critics, may have facilitated subsequent City scandals.

In the past, the LSE has had a reputation for complacency, but this is starting to change. In May 2009, Dame Clara Furse stepped down after eight years as chief executive of the LSE. Her replacement, Xavier Rolet, is a Frenchman who, like Furse, has a trading background, in his case with Lehman Brothers. He has experience of exchanges from a client perspective.

At the end of June 2009, the LSE had a 68 per cent market share of UK equities, down from 84 per cent at the start of 2008. According to the LSE's 2009 accounts, trading services accounted for the lion's share of revenues at £275 million, while the next largest source was information services at £183 million. Issuer services produced £90 million in revenues and post-trade services notched up £104 million.

Trading

The LSE dominates UK equity trading with a 68 per cent share of the total. In terms of value traded on the order book, the LSE claims it remains Europe's biggest equity market, although it is smaller than some European exchanges in terms of its market capitalisation as a company.

Until 1997, the LSE only offered one model of trading, known as quote driven, by which competing market makers quoted two-way prices in stocks on

SEAQ (Stock Exchange Automated Quotation) screens. This facility remains essentially in place today, but mainly for smaller stocks. For larger stocks, the LSE introduced the electronic order book, SETS (Stock Exchange Electronic Trading System), which has been a huge growth story.

SETS

The SETS system matches buy and sell orders automatically, where it can be done, like a game of snap. It also enables traders to enter market orders, where they trade at the price prevailing in the market at the time, or to simply hit on a displayed order. Where there is enough liquidity in a given security, trading through the order book can be more efficient than through market makers. According to the LSE's 2009 annual report, the average daily number of cash equity trades on SETS increased 15 per cent to 740,000 from 642,000 in 2008.

SETS now additionally offers displayed market maker orders in all stocks through a two-tier market structure. This includes SETS for 'liquid' stocks, where anonymous order book trading is continuous throughout the day, and SETSqx for 'non-liquid' stocks as defined under the Markets in Financial Instruments Directive (MiFID), which concentrates anonymous order book liquidity into specified auction periods throughout the day.

TradElect

The LSE has TradElect, which went live in June 2007 in London after it had already been in use on the Johannesburg Stock Exchange. On TradElect, the average time taken to process an order from receipt to execution to reporting back is, following recent performance upgrades, around three milliseconds. The trading capacity is over 20,000 orders a second.

In September 2008 the system crashed for more than six hours even though it was supposed to be 100 per cent reliable. This made the headlines, although there have also been crashes in the systems of the LSE's competitors. Project Turquoise, for example, experienced a system outage in June 2008, where it was forced to suspend trading for the morning, as well as in September 2008, and some weeks after its launch.

In mid-2009, the LSE was reviewing its TradElect trading system (see below) and, in September 2009, announced a replacement for TradElect and other interfaces. It would be acquiring MillenniumIT, a Sri Lankan-based technology services company serving the capital markets industry, for US\$30 million (£18 million). According to Rolet, improving the LSE's technology and increasing its competitive position in the fast-moving trading environment is vital. He said that this transaction would enable the group to implement a new,

more agile, innovative and efficient IT capability as well as running a new cash-trading platform which would provide lower latency, higher capacity and improved scalability.

Price transparency

According to the LSE, for liquid stocks, prices on an order book are more transparent than those advertised on the quote-driven, market maker system because they are firm, and are visible to and contributed by the entire market, rather than being solely derived from a small group of market makers. Dealers can conduct large trades for clients on SETS that influence share prices immediately and are executed automatically when the buy and sell orders match. The order book also enables traders to point a machine at the market for arbitrage or to feed in large orders piecemeal to reduce market impact, so that overall liquidity is improved.

Iceberg facility

The iceberg facility, introduced in November 2003, enables traders to enter a large limit order on the order book and reveal only part of it at any time. Once this ‘peak’ is fully executed, a new one will automatically replace it on the order book. This process of carving up the large order into tranches will continue until the order has been exercised fully or a remaining amount has expired or been cancelled.

The procedure is designed to help traders execute large orders without having an excessive impact on the price, which is a feature of tranche trading outside the iceberg system. In iceberg orders, price dictates priority, and should an intervening order at a better price be placed, the order will have to wait in the queue. The functionality is discreet and trades are not stamped ‘iceberg’, but they appear on the screen as an ordinary limit order.

If the iceberg trade is in an actively traded stock, like Vodafone, it is less likely to be detected than in a smaller, less liquid stock, but the continual refresh in the peak size of an iceberg limit order reveals the fact that it is there.

Another innovation in the same year was minimum execution size, which enables customers to stipulate the minimum aggregate volume against which the order can be executed in continuous trading. According to the LSE, this protects participants from small-volume orders, so limiting information leakage.

In September 2009, the LSE said it was to introduce that year hidden limit orders, a facility allowing participants wishing to enter large orders (for the most liquid securities, the criteria would be set by the Committee of European Securities Regulators), to enter a limit order where both the price and volume were hidden, but which would be executed if sufficient volume was found on

the other side of the order book. This meant that there would be executable liquidity which was not visible to market participants. The LSE would also introduce hidden pegged orders, which would allow participants to peg their order, or at a differential or offset, to the LSE's best bid, best offer or mid price, so that they would not need to update orders continually as the market moved.

An important part of the hidden order functionality was that users would be able to stipulate a 'minimum execution size' determining the minimum volume at which they wished their order to be executed in continuous trading. According to the LSE, this would protect participants from small-volume orders that might be submitted to the market deliberately with the hope of discovering whether any hidden orders were sitting on the book, and exploiting that information.

Auctions

The LSE opens and closes trading on SETS each day with an auction. Anybody who trades the order book has access to the auctions. By concentrating liquidity at a set point in time, the auctions set the opening and closing price for each security. Some might use the auctions to balance their books and others to fulfil a trade they want to execute. During the auction, market participants can enter limit buy and sell orders, and the LSE automatically calculates and displays the real-time uncrossing price (the mean price at which the bids and offers can be matched).

Market makers

Market makers still take part in quote-driven trading that runs parallel to the order book. They provide liquidity and price formation for those shares in which they choose to make a market. They are wholesalers of shares and may specialise.

According to the LSE, market makers provide crucial liquidity in smaller stocks. In larger stocks, investors may go to a market maker rather than SETS to achieve better trading results. If, for example, a fund manager held a stock and then wanted to get out of it because of emerging bad news, the spread (difference between buying and selling price) on the order book for selling £10 million of the stock would be perhaps 500 basis points, which was 5 per cent, reflecting nervousness about the stock's prospects. A market maker instead might let the fund manager sell £10 million of the stock at a reduced spread of 400 basis points, which was 4 per cent. This would provide certainty of trading and a better price than if the fund manager had sold it all immediately through the order book.

For small retail trades in liquid stocks, using a market maker may mean sacrificing keenness of price spread for ease and simplicity, which may be worthwhile. For more sophisticated private investors, who trade through brokers

that provide a Direct Market Access service, there may be a good reason to place orders directly on the order book.

Every stock has a notional minimum of at least one market maker, but in practice will have at least two, and mostly five or more. Competing market makers display continuous buy and sell prices on terminals globally.

The market maker is bound by the rules of the Exchange and does not have any relationship with the companies themselves, unlike in continental Europe where formal liquidity agreements are more common.

The large market makers such as Winterflood Securities can commit capital, but most market makers are part of an integrated house, and have a different business model. They may view market making as part of a corporate relationship, and are responsible for very little dealing activity.

Until June 2007, market makers in the smallest stocks on the LSE still quoted their prices through the SEAQ system, a quote-driven market through which competing market makers display continuous buy and sell prices globally on screens. Since June 2007, SEAQ has operated only for stocks on the Alternative Investment Market (AIM). It has otherwise been replaced by SETSqx, a trading service for less liquid securities, including those not traded on SETS or the less liquid AIM securities. SETSqx combines SEAQ-style quotes with periodic auctions to enable the display of unexecuted client limit orders, as required under MiFID.

The art of market making

Through the quote-driven system, market makers are committed to providing a price and to dealing in at least a certain minimum deal size throughout the trading day. They set their own prices based on their anonymous proprietary position and their knowledge of order flows, as well as supply and demand.

The market maker makes its money on the spread, which is the difference between the bid and offer price. Bid is the price at which customers can sell, and offer the price at which they can buy. A bid–offer spread of 8–10 means that one can sell to the market maker at 8p or buy at 10p.

Market etiquette suggests that the broker should reveal to the market maker the whole size of any order for which it is seeking to transact only a part. If there were 10 market makers offering one NMS (normal market sized order) each at best price, a broker wishing to conduct business of $10 \times$ NMS should reveal the full extent of its business to one market maker, which will price the business taking account of the size.

The market maker need only quote for one stock per telephone call, and if it is quoting the stock elsewhere or has not yet changed its price following an execution in it, it may declare ‘Dealer in front’ and not provide a quote. Market makers have occasionally misused this process.

Should the market maker be approached by a broker acting in a proprietary capacity, it is not obliged to deal. If the broker is large or has a strong relationship with the firm, it may be able to negotiate a price better than the spread on screen. One of the criticisms about market making is that it does not promote a level playing field.

The order book requires settlement in three working days, and trading with paper certificates is not allowed. Market makers are more flexible about when settlement is required, and paper certificates may be used.

If one market maker has dealt with another anonymously, or privately through inter-dealer brokers (IDBs), the screen price is altered. Market makers may use IDBs to balance their books. If one has bought a lot of shares, it may unload some, perhaps through an IDB, onto other market makers. But most market makers now use SETS to balance their books because it offers greater liquidity, according to the LSE. The LSE also offers registered market makers reduced prices for trading in small-cap securities.

Users

Users of the LSE trading systems include retail service providers (see below), hedge fund managers, market makers and sell-side brokers, including retail to a small degree, and member firms trading on their own account. Let us take a more detailed look.

Retail service providers

The retail service provider (RSP) network was developed by Merrill Lynch and other financial institutions, and is mutually supportive with market makers. The RSP is the interface between retail brokers and the equity markets. Brokers use RSPs for the vast majority of the 10 million plus retail trades a year. The RSP appears opaque in how it operates.

When asked by a customer for a price, the stockbroker relays the request electronically to the RSP, which will send back the best price it has determined, with reference to both the order book and quote-driven market makers.

The broker may keep his client holding on the phone (or internet) while he gets the price from the RSP, and if it is satisfactory, they can execute the trade immediately. But if the client wants to trade on the order book, the broker will place it and say, 'I'll call you back when it's hit.'

A few retail stockbrokers offer their clients the ability to put the order directly onto the order book, and a Level 2 data feed will enable the investor to watch the order's progress.

The RSP is itself a market maker in some stocks to a size limit, beyond which it will refer the trade to its own market makers, which provide a service in both quote-driven and order-book securities. Brokers choose how many RSPs they poll; it could be three or a dozen.

Brokers may use different ways to allocate the prices quoted by RSPs, and not all are equally to the trader's advantage. A large internet broker is likely to have an RSP relationship with at least five or six market makers, and it will contact all of these for quotes, the most competitive of which it will relay to the client. The price achieved on dealing may be better than quoted. Other brokers rotate RSPs in turn on the basis of one per deal, communicating the price received to the customer. Some claim that retail brokers are not always interested in getting the best price for their customers, and that they are focused solely on offering the easiest and cheapest services.

Hubs such as Proquote and Royal Blue provide a central facility for routing quote and execution messages between private client providers and RSPs. In reaction to competitive pressure, they have reduced entry costs for RSPs and brokers alike.

Hedge funds and others

Hedge funds often prefer direct market access (DMA) to the traditional model whereby they pay a broker to execute trades on their behalf. The trades still go through the broker's system, but the fund itself controls the trading, and pays much lower commissions as a result. The LSE takes the view that the price improvement so obtained offsets the cost of setting up the appropriate technology.

If hedge funds cannot spare the cash outlay for the positions in shares that they would like, or they want to keep their holdings more opaque, they may use contracts for difference (CFDs). This will affect the share price because the shares are held as security against the CFD trades. For more about how CFDs work, see Chapter 9.

Hedge funds in particular, but also investment banks and pension funds, use algorithmic trading, which is computer-based trading applying mathematical models known as algorithms. It requires fewer staff to administer than traditional trading. Algorithmic trading can split a large trade into smaller ones to reduce market impact and cut trading costs. Other strategies are designed to generate profits from large numbers of individual transactions, but are dependent on low trading costs.

Concerns are sometimes raised that algorithmic trading can power a market rise or other volatility. Some firms run programmes known as 'sniffers' that discover momentum in stocks, giving them a cue to jump onto the bandwagon. Algorithms follow many different trading strategies, which can counteract each other.

Share trading venues and exchanges

Introduction

In this chapter, we shall look at alternative trading facilities for UK equities in the competitive environment encouraged by the Markets in Financial Instruments Directive.

Overview

As the third edition of this book went to press, there were seven Recognised Investment Exchanges (RIEs) in London, some concerned with derivatives. We shall focus here on exchanges that trade UK equities. We shall also look at the multilateral trading facilities, which provide an alternative to exchanges, as well as at systematic internalisers and dark liquidity pools.

The choice of trading venue could have an impact on execution, and firms under the Markets in Financial Instrument Directive (MiFID) are required to have a best execution policy.

To achieve best execution (discussed in Chapter 23), a firm may reasonably use only one trading venue, if it can demonstrate that in this way it gets the best possible result. Occasionally it may get a worse price than elsewhere, but this is acceptable if it would not be economical for the firm to move venues on that business.

Let us now look at some of the trading venues.

Exchanges

For details of the London Stock Exchange (LSE), see Chapter 15. We shall look briefly at PLUS Markets Group, since it is the only other exchange trading equities currently authorised to operate primary as well as secondary markets.

PLUS Markets Group

PLUS Markets Group provides a listing and quotation destination for companies wanting to raise funds and have their shares traded in London (see Chapter 6). It also offers share-trading services as well as real-time regulated information feeds of market data. Eligible companies worldwide can be admitted to the PLUS platform.

Despite its differences from the larger LSE and its small-cap focus, under MiFID, PLUS can provide trading facilities not only for its own admitted companies, but in over 7,500 UK and European securities, including the FTSE-100, FTSE SmallCap and, since August 2009, all AIM shares.

In April 2009, PLUS had a 2.6 per cent share by value (turnover) of all UK equities, compared with 49.1 per cent for the LSE (PLUS Markets Group, 2009). However, it had 7.9 per cent by volume (number of shares traded). The dealing tariff makes it cost-effective for brokers to transact retail-size orders through PLUS, and there is no fee for membership. According to PLUS, one in three of all retail equity trades executed in the United Kingdom is transacted on its platform.

In individual stocks, PLUS's market share can be much higher. In April 2009, PLUS attracted a 30 per cent share by value in the Royal Bank of Scotland shares traded, and 19 per cent in Barclays.

All trading on PLUS is quote-driven rather than transacted through an electronic order book. Trading data is available through data vendors, such as Bloomberg and Reuters, and retail resources such as ADVFN. As well as providing trading data for all those securities trading on its platform with a 15-minute delay, PLUS provides for its PLUS listed and quoted companies monthly data on trading volumes, new and secondary issues, amounts raised, as well as links to news, regulatory announcements, trading results, and other news and data of use to investors.

PLUS now claims to be the second largest equity growth market in Europe. It has been developing its primary market and broadening its service offering, and is working with advisers on bringing non-standard products to the market.

Multilateral trading facilities

Multilateral trading facilities (MTFs) are trading systems owned by investment companies or market operators. Unlike exchanges, they are focused on the most

liquid shares. They bring together buyers and sellers of selected shares, bonds or derivatives, and enable them to trade.

The MTFs compete in the same trading space as exchanges, but unlike them, do not get involved in new issues of securities and the dissemination of listed company information, and do not operate other businesses such as post-trade services or derivatives platforms. The MTFs include Chi-X, the market leader, Turquoise, owned by a consortium of investment banks, BATS Europe as well as Nasdaq OMX Europe and Equiduct.

In the post-MiFID trading environment, the MTFs have gained market share in Europe. IFSL's *Equity Markets* June 2009 report using Thomson Reuters data (IFSL, 2009a) indicated that MTFs accounted for nearly 40 per cent of trading in European equities in 2008 and early 2009, up from 25 per cent in November 2007.

Chi-X

Chi-X was launched in March 2007 as the first of the MTFs and trades around 800 blue-chip stocks. It was established by Instinet, a subsidiary of Japanese broker Nomura, and operates in the United Kingdom and Canada.

Trading a share on its platform takes one to two milliseconds, provided that clients put up servers at the Chi-X data centre by leasing space on Chi-X's server rack. On the LSE's platform, trading takes longer (see Chapter 15).

Chi-X has a cheap fee structure using a rebate model, where liquidity providers are rewarded with a larger rebate than liquidity takers. Unlike exchanges, it provides market data free of charge.

Compared with exchanges, the MTSs are nimble and are not similarly encumbered with legacy trading systems. The selling point is that they trade faster than the exchanges and at a lower cost. So far, however, margins are thin and there are doubts about the sustainability of the MTF business model.

The MTFs may diversify by expanding beyond equity trading to different asset classes. This strategy may run into the problem of changing demand levels, but it helps to justify the cost of the trading platform. Obligations can be netted across asset classes.

Systematic internalisers

A trading firm may become a systematic internaliser (SI). This is an investment firm, which, on an organised, frequent and systematic basis, deals on its own

account by executing client orders outside a regulated market or an MTF. Each regulator must maintain and publish a list of SIs.

In theory, the SIs can pose serious competition to the exchanges and MTFs. However, the small number of registered SIs so far, amounting to about a dozen, including several from one banking group, suggests that the business model is unattractive.

Dark liquidity pools

Since the MiFID was implemented, dark liquidity pools have gained in popularity in Europe. They are electronic trading venues where institutional investors can buy and sell large blocks of shares without the user's order being displayed publicly. They are typically self-standing, but in February 2009, NYSE Euronext launched Smartpool, a dark pool. The competitive advantage here is that Smartpool is to join NYSE Euronext's universal trading platform, which will give existing customers access to the market.

The dark pools, like exchanges, match buyers and sellers. There is no publication of the trade until after execution, and the traders value this anonymity. It means that an order placed does not influence other trades, and so the share price is not impacted in advance of execution. Dark pools are a method of achieving 'best execution' as required by the MiFID, particularly for large or block orders and trading in less liquid stocks.

There are types of 'gaming' that exploit the dark pools. One technique is when traders send a lot of buy or sell orders into a dark pool. If they hit it right and get an execution, this can indicate the price of some of the larger orders in the pool, which is information from which they can profit. Another trick is to buy stocks in small amounts on conventional exchanges and sell them as a block in a dark pool; this is easier with small-cap stocks because of their thin market and prices that change easily with even marginal trading volume. Traders usually get away with gaming, but it can involve market manipulation. In the United States, in late 2009, the Securities & Exchange Commission has been investigating issues of transparency around dark pool trading and possible regulation to see that inequity is avoided, at the same time as recognising that large trades have to take place.

Consolidation

Among exchanges across Europe and the United States, there has already been significant consolidation in the interest of creating efficiencies.

In April 2007, the New York Stock Exchange (NYSE) completed a merger with Euronext, which had itself been formed from the union of the Paris, Amsterdam, Brussels and Lisbon exchanges, through which it obtained the London-based LIFFE futures exchange.

In the same month, Deutsche Börse, the German stock exchange, announced it was buying International Securities Exchange, the US options exchange, for US\$2.8 billion.

One month later, Nasdaq, the US high-tech exchange, said it would be buying OMX, the Nordic exchange group, for US\$3.7 billion (£1.9 billion). The combined group expects to focus much of its efforts in London.

In June 2007, the LSE (see Chapter 15) agreed a merger with Borsa Italiana, valuing the Italian exchange at £1.1 billion. The LSE said that the combined group would operate the most advanced trading platform of any exchange and the most efficient post-trade services in Europe.

There is talk of consolidation among MTFs, which have not all achieved expected revenues, and this could include consolidation with exchanges, as happened with alternative trading platforms in the United States some years ago. In early October 2009, the LSE issued a statement confirming it was in exclusive talks with Turquoise, which could lead to a transaction.

Post-trade services

Introduction

In this chapter, we shall focus on post-trade services, mainly clearing and settlement, in the equity markets particularly. We shall see how professionals run these services in London and continental Europe, and consider what changes may occur.

We shall also focus on the progress achieved in the pursuit of greater competition and efficiency in the clearing and settlement of transactions across European Union (EU) borders – a more expensive process than clearing and settling a domestic transaction in an investor's home country. The driving force here is the European Commission.

Overview

Clearing defines the obligations of the parties to a securities transaction and assigns accountability. Clearing service providers are increasingly taking on the role of central counterparties (CCPs), standing between the buyer and seller of securities to eliminate counterparty risk. Many CCPs net trades between the same counterparties involving the same security before settlement takes place.

Settlement occurs when assets are actually exchanged. At this point, investors pay for and receive the securities bought, and conversely, receive payment for and relinquish securities sold.

Clearing and settlement often takes place in the home country of the securities. Dealers in London may use an agent bank to organise their foreign stock transaction clearing and settlement abroad or, if volumes justify, they open accounts with foreign central securities depositories (CSDs) and CCPs. Most cross-border European equity, bond and repo transactions are settled through

international central securities depositories (ICSDs) or by using intermediaries to reach the CSD of the foreign security. We look at these methods later in this chapter.

Clearing

Clearing is the link between trading and settlement. A CCP becomes both a buyer to every seller and a seller to every buyer for eligible equity trades. This gives anonymity to trades, pre- and post-trade. The CCP assumes monetary and securities delivery risk, and collects a margin from the trading parties to make the clearing process secure. The CCP has a second role in clearing, which is to establish 'who owes what to whom'.

Originally, LCH.Clearnet was the only CCP in the United Kingdom. The system worked well and the CCP never had to tap its member default fund, backed by an insurance policy. Since the first half of 2007, the London Stock Exchange (LSE) has phased in competitive clearing, giving customers the choice of clearing their trades through LCH.Clearnet or another CCP called SIX x-clear, which is part of the SIX Group in Switzerland. Both CCPs offer gross or (the preference of most investors) net clearing. The efficiency of netting is that it reduces the number of trades that will be settled by as much as 98 per cent. All the buy and sell trades in the same security from the same firm are added to or subtracted from its account, enabling a single netted transaction to be settled.

Settlement

Settlement is the point in a transaction when the buyer and seller exchange securities for cash. The process has not always worked as well as it does now through Euroclear UK & Ireland. Until August 1996, the LSE handled its own settlement of share trades, but not efficiently. Following the 1986 market deregulation known as Big Bang, trading volumes exploded, which put extra pressure on the LSE's Talisman settlement system.

The LSE decided to replace Talisman with Taurus, which was designed to bring about compulsory dematerialisation of all UK corporate securities. Critics said it tried to satisfy too many conflicting market interests. On the advice of two management consultants, the LSE abandoned the Taurus project in March 1993 and decommissioned Talisman in April 1997.

At the LSE's request, the Bank of England established a securities settlement task force chaired by its director, Pen Kent, which recommended a

The growing need for post-trade flexibility and automation

The Markets in Financial Instruments Directive (MiFID) has transformed the near-monopoly, but highly effective, capital market infrastructure into a field of competition. As a result, the trading and post-trading landscape has changed significantly over the past two years.

With more than 25 multilateral trading facilities (MTFs) operating in Europe alongside conventional stock exchanges, competition has driven down transaction costs. On the other hand, with this influx of MTFs and nearly as many new central counterparties (CCPs) emerging, Europe's capital market infrastructure has become increasingly fragmented.

For transaction settlement providers like Euroclear, this trend has emphasized the need for flexibility in building relationships with the new CCPs and trading venues. Euroclear UK & Ireland is settling trades for many of these new entrants, helping clients to centralise as much of their settlement activity in one location as possible to retain the benefits of economies of scale.

Moreover, Euroclear UK & Ireland has taken on some of the clearing-related functions, such as trade netting, for CCPs that choose to outsource this aspect of their role, in order to keep clearing costs low. In fact, Euroclear UK & Ireland has reduced its clearing-related tariff by 70% over the past three years as volumes rose. Overall, the cost for Euroclear UK & Ireland's services account for less than 10% of the total cost of a transaction conducted on the London Stock Exchange. Further efforts will help reduce these costs even more.

New ways to reduce risks

Market infrastructures like Euroclear were seen as 'safe havens' by market professionals during the recent financial crisis. Operating under highly regulated, risk-averse business practices, all of the infrastructure service providers globally performed as expected, processing record peaks in settlement activity and working with administrators, regulators and clients to manage the ramifications of some failed institutions.

Partly because all of the transaction processing performed by Euroclear UK & Ireland is automated and standardised, operational risks are low. Working closely with the market to design the right solution, Euroclear UK & Ireland introduced in late 2009 the UK's first automated means to process UK fund transactions.

UK fund processing automation

With EMXCo, the UK's leading provider of investment-fund order routing, becoming part of the Euroclear group in 2007, the plan was to integrate EMX order routing with the proven settlement and asset servicing capabilities of Euroclear UK & Ireland. Together, Euroclear and EMXCo are delivering end-to-end, straight-through processing of UK fund transactions for UK investors.

According to HM Treasury, the UK funds industry could save £70-290 million per year by embracing processing automation in place of paper-based fund unit settlement.

More specifically, market professionals involved in the UK fund industry are now able to benefit from substantial savings on their current operational processing costs by moving from manual to automated order routing and settlement. For example, a fund distributor settling around 10,000 transactions a month today may expect to pay up to £50,000 per month for administering these settlements and subsequent reconciliations. Now, the same distributor doing the same levels of business can expect a monthly bill for all balance reconciliation, transaction management and communication services of less than £8,000. Clients processing lower volumes of transactions can also expect to make significant savings.

In addition to cost savings, the EMXCo/Euroclear UK & Ireland initiative will decrease settlement risks and processing errors, while improving accuracy in transaction reporting. Manual intervention in UK fund processing can now be eliminated. Furthermore, up-to-date fund balances, which are reconciled by Euroclear UK & Ireland with the fund register on a daily basis, in full compliance with FSA rules, are now available electronically.

Funds domiciled in the UK, Channel Islands and Isle of Man are currently eligible for this service. Coverage will be expanded in 2010 to automate cross-border transactions in UK funds and to ease access to foreign funds for UK investors.

Euroclear UK & Ireland is the central securities depository (CSD) for the UK and Ireland, settling transactions in a wide range of domestic and international securities worth more than £200 trillion per annum. Having become part of the user owned and user governed Euroclear group in 2002, Euroclear UK & Ireland is a sister company to Euroclear Bank, the international CSD, as well as the national CSDs of Belgium, Finland, France, Sweden and the Netherlands.

For more information, please consult www.euroclear.com.

phased introduction of more cost-effective settlement for UK equities, including rolling settlement. CREST was to be the new settlement system for UK equities and bonds.

Euroclear UK & Ireland Limited owns the CREST system. The company is the UK arm of the Euroclear group and was capitalised in October 1994 under its previous name CRESTCo. This is the United Kingdom's only CSD. Currently, Euroclear UK & Ireland receives settlement instructions from clients of the LSE, as well as netted settlement instructions from LCH.Clearnet. The Euroclear group owned 15.8 per cent of LCH.Clearnet until November 2009, when it redeemed all of its shares as part of an LCH.Clearnet share-rebalancing initiative. Euroclear UK & Ireland also receives settlement instructions from Eurex, part of the Deutsche Börse Group, which also clears trades for the Irish Stock Exchange, and a growing list of CCPs serving the new multilateral trading facilities (MTFs). Euroclear UK & Ireland settles transactions in Irish equities and UK money market instruments, bonds, equities and investment funds, but not futures or other derivatives trades, which are settled between counterparties directly. CRESTCo settled its first transaction in August 1996.

In those early days, trades settled on a gross basis, that is, transaction by transaction. Netting was launched in July 2002. Euroclear UK & Ireland receives gross LSE trades, assesses them for stamp duty, nets and dispatches the relevant trade information to LCH.Clearnet or SIX x-clear, as CCPs serving the LSE, and provides a transaction report for the Financial Services Authority (FSA) once the transactions are settled. Trades executed on MTFs are netted by the relevant clearing house.

Settlement takes place through Euroclear UK & Ireland on settlement day, no matter how long the agreed settlement period, which is the time between the trade date and settlement date. Most trades settle on T+3, meaning three days after trade date. Settlement is a real-time electronic process conducted on a delivery-versus-payment basis, involving the simultaneous and irrevocable transfer of cash and securities, with legal title. Settlement is in 'central bank money', and cash movements are ultimately reflected in accounts held at the Bank of England, facilitated by appointed commercial banks serving as settlement banks for Euroclear UK & Ireland. Each settlement bank maintains a pool of cash resources with the Bank, part of which is reserved for settlement-related payments.

Clients of Euroclear UK & Ireland, including stockbrokers, custodians, fund managers, market makers and all forms of intermediaries, each have an account with a settlement bank. The settlement bank transfers cash payments for clients to and from each other during the day, using CHAPS (the Clearing House Automated Payments System) for payment in euros, and the Bank of England's RTGS (Real Time Gross Settlement) system for sterling.

After each settlement cycle, Euroclear UK & Ireland's systems automatically notify the Bank of England's RTGS system of the inter-bank payments made. RTGS releases earmarked funds that were not used, allowing the settlement banks to rebalance their liquidity levels before they restart the process.

Euroclear UK & Ireland's settlement rate is around 98–99 per cent by value, and 96–97 per cent by volume. The failures are typically because a broker has not received the stock from its client. Euroclear UK & Ireland runs a 'settlement discipline regime'. If there is a breach of matching or settlement standards, Euroclear UK & Ireland may impose a fine or take other disciplinary action.

Safekeeping and custody

Euroclear UK & Ireland offers corporate action and other custody-related services, but not safekeeping as such. Euroclear UK & Ireland maintains the legal record for UK securities and sends electronic updates to the registrars every time there is a change in securities ownership. While the legal record remains with Euroclear UK & Ireland, the registrars reconcile and maintain a record of the positions in their systems. Some foreign banks and insurance companies deal with Euroclear UK & Ireland through a local or global custodian. These entities safeguard the financial assets of their customers, processing their trades and corporate actions, such as dividends and interest collections, rights offerings, scrip issues and takeovers. The custodian typically offers value-added services such as portfolio performance measurement, securities lending desks, fund administration, tax services and a range of banking services.

Registrar services

After settlement, Euroclear UK & Ireland notifies the registrar appointed by the security's issuer of the change in the security's ownership. Among UK registrars are Lloyds TSB Registrars, Computershare and Capita Registrars.

The balance of assets held through Euroclear UK & Ireland must be reconciled with the registrar four times a year.

Managing crises

Euroclear UK & Ireland is regulated by both the FSA and the Bank of England, and has proven to perform very well under stressful circumstances.

When Lehman Brothers collapsed in 2008, Euroclear UK & Ireland and LCH.Clearnet were able to quickly and efficiently identify Lehman's open

positions with other banks so they could be closed out with minimum market disruption. They worked closely with the Bank of England and Lehman's appointed administrator, PricewaterhouseCoopers, to resolve outstanding issues in an orderly manner. When Barings collapsed in 1995, a similar result was achieved.

A changing competitive environment

Introduction

Across Europe, there is a push for greater competition between service providers in each of the three tiers of market infrastructure: trading, clearing and settlement. Some countries operate with vertical silos, where the stock exchange owns the clearing and settlement service providers for all domestic securities. Among those exchanges that have vertical silos of some kind are Deutsche Börse, SIX Group in Switzerland, Borsa Italiana and Bolsas y Mercados Españolas, the Spanish stock exchange.

Other countries operate a horizontal model where each market tier is independent of the other, but integrated. In the past, the LSE was a strong supporter of the horizontal model, but since acquiring Borsa Italiana in 2007, it has become reticent. LCH.Clearnet and Euroclear are examples of the horizontal approach. NYSE Euronext's situation is complicated, mixing both models. The London derivatives market is vertically integrated, owning its own clearing house, NYSE Liffe Clearing. Trades on its continental European markets continue to be cleared through LCH.Clearnet.

The Markets in Financial Instruments Directive

After the Markets in Financial Instruments Directive (MiFID) came into effect in November 2007, and the introduction of multilateral trading facilities, the number of trading venues and CCPs in Europe has multiplied. The monopolies enjoyed by stock exchanges have gone. The fortunes of the exchanges and multilateral trading facilities are more influenced than ever by the choice of clearing and settlement venues they provide to clients.

Under Article 34 of the MiFID, investment firms from one member state have right of access to central counterparty clearing and settlement systems in another member state, which should reduce costs through the promotion of cross-border service competition. In principle, under MiFID, investment firms must select the trading, clearing and settlement systems that will achieve best execution for their trades within the European Union.

EU Code of Conduct

The European Commission has considered a directive on clearing and settlement, but so far has rejected the idea on grounds that it might have adverse consequences, including slowing down the progress already made to both reduce cross-border clearing and settlement costs, and to harmonise market practices.

The European Commission instead proposed in July 2006 a Code of Conduct for clearing and settlement, starting with equities, to improve competition in the sector. The Code, signed in November 2006 by all of the EU trading, clearing and settlement infrastructures, has three pillars: (1) price transparency; (2) access and interoperability; and (3) service unbundling. The first and third pillars have been fully implemented, and the second is work in progress.

According to SWIFT, access is about getting to where you want to do business, and interoperability is about doing business when you have got there. It is the part related to access and interoperability, leading to greater competition, that is the biggest challenge. Interoperability allows a clearing or settlement provider in one EU market to receive transaction feeds directly from the local stock exchange or clearing facility in another.

One of the obstacles is that the capital market infrastructures that operate as vertical silos are effectively monopolies. In addition, post-trade service providers are hesitant to open up the markets they serve to competition without reciprocal arrangements in place to access the relevant part of the foreign market infrastructure seeking to offer a competing service.

At a July 2009 meeting focused on access and interoperability challenges by the Monitoring Group on the Code of Conduct on clearing and settlement, the LSE made the case that it was one of the only trading venues so far offering competitive clearing, giving clients a choice of LCH.Clearnet or SIX x-clear. The LSE was not willing to invite further CCPs to compete until other markets progressed on their access requests. LCH.Clearnet is in the process of inter-operating with several CCPs.

The European Commission and other authorities are seeking to unblock requests for access and interoperability, partly by analysing whether some infrastructure service providers are protected by artificial barriers of local regulation, law and market practice. For example, in September 2009, the Court of First Instance dismissed the appeal brought by Clearstream Banking Frankfurt, part of the Deutsche Börse Group, against the European Commission's decision in 2004 that found Clearstream guilty of abusing its dominant market position in Germany by unlawfully refusing to provide certain services to Euroclear Bank.

Giovannini Group barriers

The Giovannini Group, a team of market experts led by Alberto Giovannini, chief executive of Unifortune Asset Management, was appointed by the European Commission to focus on market practice, legal and regulatory inconsistencies within clearing and settlement in Europe. Its reports in 2001 and 2003 have spurred moves towards a more efficient and coherent pan-European approach to clearing and settlement.

In response to the first barrier (Giovannini Barrier 1: National differences in the information technology and interfaces used by clearing and settlement providers should be eliminated via an EU-wide protocol) SWIFT led an industry-wide consultation which resulted in the publication of a clearly defined ‘Giovannini’ protocol with implementation recommended for all domestic and cross-border clearing and settlement parties by March 2011.

So far, progress towards eliminating the 15 identified barriers has been mixed. Little has been done to remove the nine public-sector barriers, whereas progress is being made to eliminate the six private-sector barriers. In almost every case, there remains work to be done.

The European Commission remains committed to its goal of creating a single, harmonised European market for financial services. Under the new European Commission in 2010, a clearing and settlement directive could return to the agenda to increase the pace of industry change.

SWIFT and BT are the main providers of communication solutions of the type required to overcome Giovannini Barrier 1. A SWIFT discussion paper (2009: 3) reported on findings that some infrastructure service providers, unlike financial institutions, might not be ready to overcome this first Giovannini barrier. CSDs were not all prepared to meet common standards in IT and interfaces. The CCPs were even less prepared.

Cross-border players

Agent banks and ICSDs

Given the increasing integration of Europe’s securities markets, the European Commission wants seamless, competitive and safe clearing and settlement services. There is still a variety of providers. When securities are trading across borders, transaction settlement is relatively expensive and complex, and can involve multiple intermediaries, all of which charge a fee.

Investors usually choose to settle multi-market, cross-border trades through either one or a combination of agent banks, which sell a wide range of

value-added post-trade services, or international CSDs (ICSDs), which provide more commoditised wholesale services. As the Giovannini Group barriers are eliminated, investors may find it advantageous to access local CSDs directly.

The agent banks, which do not report market share figures, may use CSDs and ICSDs to settle trades for their clients, or may settle client trades on their own books. The agent banks offer value-added services such as portfolio valuation and fund administration services. They may offer their services across multiple markets, or perhaps specialise in transaction services to foreign investors in their home market. Accordingly, their service charges are at the high end of the spectrum.

They compete with Europe's two ICSDs: Euroclear Bank, a wholly user-owned bank that is part of the Euroclear group, and Clearstream Banking Luxembourg, wholly owned by Deutsche Börse. Each of the two ICSDs provides settlement, custody and related services for domestic and international securities transactions. They are the model of interoperability, as the two are interconnected by an electronic bridge, enabling a customer of one ICSD to settle a trade with a customer of the other.

An ICSD has a higher cost base than a CSD, because of the multi-currency, multi-market complexities of its service offering, but is substantially less expensive than an agent bank.

Euroclear's Single Platform

By mid-2009, Euroclear had completed four-fifths of a phased move to its Single Platform, which aims to consolidate its seven existing transaction-processing platforms into one. The platform will address all processing requirements for settlement, custody, issuer services and other types of transactions in more than 50 currencies.

Euroclear started by launching a Single Settlement Engine for five markets in 2007. In January 2009 it launched the Euroclear Settlement of Euronext-zone Securities (ESES) platform. This enabled market participants in Belgium, France and the Netherlands to process all equity, fixed-income, and other domestic securities transactions through the same platform. Cross-border transactions between counterparties in these three markets are processed as if they are domestic transactions, at domestic settlement prices. In line with the Giovannini Group recommendations, market practices within the three markets have been harmonised, thereby eliminating the complexities, risks and excessive custody and settlement costs of cross-border transactions.

Launch of the ESES platform also means that user firms may rationalise their back offices and save money by using one team and one infrastructure to process trades in three markets, in a standardised way. It became cheaper and

easier for a client to access the CSDs of Belgium, France and the Netherlands directly from a single location, as an alternative to using an agent bank or ICSD. The single order book put in place by NYSE Euronext is complementary to the ESES platform, making it easier for listed companies to raise capital from a larger pool of investors and liquidity.

Euroclear will launch the next phase of its platform consolidation programme in 2010, when all custody operations for five of its seven markets will be processed on the Single Platform. In 2011, all collateral management operations for these markets will migrate to the Single Platform, providing more than 18 trillion euros of securities that may be used as collateral to cover trading and securities finance exposures across markets.

Euroclear's Single Platform programme, which has a wider scope than TARGET2-Securities (see below), has met with strong market buy-in. Most, if not all, of the market rules practised within all seven Euroclear CSD markets will be identical and in line with the rest of Europe. No other group of European markets will have delivered as much in removing many of the barriers to cross-border settlement identified in the Giovannini Group reports.

Euroclear plans that its Single Platform will be completed for Ireland and the United Kingdom by mid-2012, after which the Finnish and Swedish markets will be migrated.

TARGET2-Securities

In summer 2006, the European Central Bank (ECB) announced a plan to build its own euro-zone securities settlement infrastructure, called TARGET2-Securities (T2S), which the European Commission has supported. Under the plan for T2S, scheduled for delivery in 2013, the ECB would in-source all settlement processing currently conducted by private-sector CSDs in the eurozone as the single provider of settlement processing activities in central bank money. The CSDs would continue to provide all other related processing services, such as custody, collateral management and issuer services. The idea was to achieve lower costs and settlement risks through the development of scale by centralising securities transaction settlement on the T2S platform.

The Bank of England has taken a non-interventionist interest in the T2S debate, which is relevant to the City of London, from where 40–50 per cent of EU financial services business originates. In July 2009, the Eurosystem and the CSDs of all eurozone countries, seven EU countries outside the euro area, and two CSDs from countries outside the European Union, signed a Memorandum of Understanding (MoU) on T2S. Jean-Claude Trichet, president of the ECB, said in a speech that this would pave the way for decisions needed in preparation for the project's development phase, scheduled for early 2010. Further

discussions would cover T2S governance, the pricing structure and contractual relations between the Eurosystem and the CSDs.

A project update by Marc Bayle, T2S project manager at the European Central Bank (Bayle, 2009), claimed that the signed MoU was important because it showed strong support for T2S among market participants, and it was the next step towards the legally binding framework agreement which would commit CSDs to using T2S.

The T2S project will require Giovannini Group compliance for connectivity by its user community, which according to SWIFT is proving a significant driver in focusing the attention of the CSDs on compliance.

The Depository Trust & Clearing Corporation

The Depository Trust & Clearing Corporation in the United States has introduced its own CCP clearing organisation into Europe to support several of the MTFs, but primarily Turquoise, which is now up for sale. The new organisation, European Central Counterparty Ltd (EuroCCP), operates at cost rather than profit, is governed by users, and leverages the economies of scale provided by its parent corporation to lower its cost. Clearing is available on a pan-European basis, which from early 2009 has included 15 European markets. EuroCCP clears trades done through MTFs that submit trade data to it, and completes settlement at each of the national market CSDs in the 15 markets (such as Euroclear UK & Ireland) using Citibank as EuroCCP's settlement agent.

Link Up Markets

Link Up Markets is another initiative to reduce cross-border settlement costs in Europe. It is a joint venture which will establish links between eight European CSDs and the South African CSD to facilitate access to the services of the other participating CSDs across all asset classes (except derivatives). Link Up Markets will absorb any differences in communication standards across these markets. Thus, it will route orders between CSDs, eliminating the need for intermediaries. However, it will not consolidate systems or reduce the technical running costs of any participating CSD. Euroclear is not among the founding members, but like every other CSD in Europe, is invited to join Link Up Markets.

The future

The major criticisms of the European post-trade industry, with which London is inextricably linked, are that it is fragmented, costly and inefficient with regard to cross-border transactions. Europe's capital market infrastructure was originally

created market by market, with each country having its own trading and post-trading venues and market practices. They were not designed to be interoperable or to service foreign securities transactions.

As a result of MiFID and the introduction of MTFs, there are now many more trading venues and CCPs in Europe. A shake-out leading to consolidation and cheaper services is widely predicted.

In post-trade services, Europe is often compared with the United States where DTCC is one of only two entities specialising in clearing and settlement. Its service charges are lower than any equivalent domestic settlement provider in Europe, mainly due to economies of scale. The comparison is invidious because the United States starts out at a major advantage of being a single market operating in one currency, one language, and under a single fiscal and regulatory regime, while Europe is a collection of individual markets, each with its own set of operations and idiosyncrasies. In Europe, cross-border transactions are complex, and often six to seven times more expensive than domestic transactions to clear and settle.

Charlie McCreevy, European Commissioner for the Internal Market and Services, has given the clearing and settlement industry its own chance to create a more competitive and efficient pan-European environment through MiFID and the Code of Conduct, but should this fail, he has said there will be mandatory measures. There is talk of improving the supervision of clearing and settlement on the basis of standards jointly provided by the Committee of European Securities Regulators and the European System of Central Banks, which have some overlap with the Code of Conduct, but are much more prescriptive.

If the ideal of a harmonised Europe is reached, there will be no difference in market practices between one market and another. The agent banks make their money from managing market differences and inefficiencies for clients, and may find that some of the value-added services they offer today will no longer be in demand. If they are to survive, they may be forced to adjust their business model, which may well involve moving into new services and to more markets outside Europe, such as Asia and South America.

Within the European Union, infrastructure service providers could help reduce risks through efficiency improvements. According to Euroclear, inefficiencies are a source of operational risk, which contributes to higher capital requirements for banks under Basel II. Any cuts in IT budgets, operational expenditure or headcount must not jeopardise the market infrastructure's readiness and sound risk management, as the markets rely on it for transaction, credit and liquidity flows, and for uninterrupted service during market crises, as and when they arise. Therefore, risk management and efficiency improvements often go hand in hand.

Euroclear and SWIFT believe that consolidation is an inevitable part of the future post-trading landscape and that restructuring is needed, to reduce costs as well as systemic risks. Neither firm is a proponent of the US monopoly approach to clearing and settlement. Rather, competition, as we have in Europe, is the right approach to keep costs low and encourage innovation.

The European Commission recently announced the results of a study on the prices, costs and volumes for trading and post-trading of securities in the European Union (Oxera, 2009). It found decreases in costs for trading, and to some extent for settlement services, since 2006. The survey also found that volume determined prices and that domestic activity was much larger than cross-border activity. And, although settlement costs continued to be higher for cross-border transactions, they represented less than 1 per cent of the total cost of a cross-border transaction.

It is clear that the European Commission remains dedicated to its original target of creating a single European market for financial services. Failure to do so will most likely result in further legislation.

Investors

Introduction

In this chapter, we shall take an overview of the types of investor operating in the City. We look first at retail investors, then turn to institutional investors. Read this with Chapter 19, which covers pooled investments.

Retail investors

The retail investor market in the United Kingdom is large, and many smaller stockbrokers specialise in serving retail investors' needs. By number of trades, private clients have a significant share of the market. To provide latest statistics for the third edition of its book, Compeer, a specialist in benchmarking, competitor analysis and research services, found from its own database that 18 per cent of the number of bargains traded through LSE members in 2007 were from retail investors. In terms of sums invested, however, private clients had less than 1 per cent of the total, although they also put cash into pooled investment schemes, which were used to invest across asset classes, including the stock market.

Some retail investors buy shares and hold them for the medium to the long term, while others trade them over a short period. Traders can make money from stock markets when there is volatility. They can take short positions to gain profit from pricing downturns, as well as long positions to benefit from upturns. In bear markets, retail investors and traders alike often make the mistake of hanging on to loss-making positions too long.

Market gurus encourage retail investors and traders to make their own investment decisions. There is much advice available from newspapers and magazines, financial websites and their message boards, some of which is poor

or biased, and some more valuable. The Investment Management Association (IMA) July 2009 *Great British Investor report* (YouGov, 2009: 5), found that financial websites remain the most popular source of information, used by 54 per cent of investors, compared with 47 per cent a year earlier. The report found that many consulted websites of newspapers and money magazines rather than service providers' websites.

Most retail investors do not have the same information resources as professionals, and they may have limited understanding of company accounts or how markets work. The Financial Services Authority (FSA) constantly recommends that retail investors should seek professional financial advice.

Some choose to invest as a hobby with others in an investment club. This can be an enjoyable, interesting and successful experience, combining a get-together among friends and colleagues with learning about and investing in the stock market. The club structure enables like-minded individuals to meet on a regular basis, and everyone contributes an agreed regular sum, perhaps £30 a month, to an investment fund. This finances the club's purchase of shares in companies researched and recommended by club members. Because investors have pooled their contribution, the club has bigger buying power. A broker will be more interested in a trade with £5,000 than one with £500.

Institutional investors

Institutional investors are financial institutions that manage savings collectively for small investors. They include investment companies, life insurance companies and pension funds. Sometimes the institutional investor is also the fund manager, and at other times the two functions are separated.

The IMA's *Asset Management in the UK 2008* (IMA, 2009a: 13) found that assets managed in the United Kingdom by all IMA member firms totalled £3.0 trillion on December 2008, down 11 per cent year on year.

Let us see how fund managers work, followed by insurance companies and pension funds.

Fund managers

The fund manager decides how to invest money held in a fund, whether it is a pension fund, an insurance fund or an investment fund. The fund manager may be an independent investment firm, such as Fidelity, or part of a bank or an insurance company. Insurance companies and pension funds may use external fund managers to manage wholesale money because it enables them to diversify their risk, and to have access to managers specialising in particular markets.

Contrary to popular belief, conventional fund managers have far more trading power than hedge fund managers (see below). They can move prices by their buy and sell decisions, and by accepting or rejecting a bid for a company in which they hold shares, may determine the success of the bid.

Fund managers cannot invest in anything they like, as they are subject to asset allocation and asset eligibility requirements. Some funds invest in large blue chips, others in small companies, some in the United Kingdom and others abroad. These boundaries are known as the fund manager's universe.

Some fund managers are top-down, which means that they start with the global macroeconomic view and, within this framework, select individual stocks. Other fund managers are bottom-up, which means that they focus initially on individual stocks, and only then move on the broader picture.

An independent trustee monitors the fund's compliance with its investment objectives, and fund management firms have their own monitoring procedures and controls.

Hedge fund managers

Hedge fund managers aim at absolute returns, regardless of market conditions, and their funds tend to make more money than conventional funds. They are often run by ex-investment bankers and other specialist financiers who give up highly lucrative jobs to set up a fund, and who know enough about markets to exploit a sophisticated toolset of modern investment vehicles.

Hedge fund managers normally invest their own money alongside that of investors, and will usually reveal how much. They are attracting the capital of sophisticated investors including, increasingly, pension fund managers who use hedge funds as a relatively new way to diversify their funds in a way that is uncorrelated to their equity positions.

Hedge fund managers use increasingly diversified strategies. The best known of these are derivatives-related arbitrage, which means making money by exploiting small available differences in price, and long/short equity funds, which involve, for instance, buying Shell because they think it will go up and shorting BP because they think it will go down, so they are sector neutral.

A variation is fixed-income arbitrage. The strategy involves trading two bonds, both of which mature within a given time period, in the same currency, with the same credit and liquidity risks, but with different yields. The trader believes that the bonds should have *mean reversion*, and that bond A will have a declining yield and so a rising price, and conversely bond B will have a rising yield and so a falling price. The trader will buy bond A, which is to go *long*, and use it as collateral to borrow bond B, on which they go *short*. In this way, the trader seeks to make a profit on the yield and price differences between the two

bonds in the belief that it will be temporary. The trader will not worry if rates rise or fall, but will simply want the gap between the yields, and so the prices, to narrow to neutral. The trader will make a loss only if the gap widens. In practice, a hedge fund may take 40 or 50 such pairs, of which some will go wrong, but a majority should go right.

Hedge fund managers do very little pure short selling, which has unlimited downside risk. They often move markets at sensitive times, including during the book build for a new securities issue. For a more general look at hedge funds and how they work, see Chapter 19.

Insurance companies

According to the IMA's 2008 asset management survey, insurance companies have 32 per cent of the total institutional assets under management of IMA member firms in the United Kingdom, behind only corporate pension funds, at 37 per cent.

Insurance companies invest premiums received from the insured to increase their reserves. There are two kinds of insurance business. The first is long-term insurance, which is mainly life insurance, and the second is general insurance, which provides, for example, motor or household insurance cover, and needs short-term liquid assets to meet claims in short-term policies.

According to the IMA survey, a large majority of insurance client assets are still in-house funds, managed by asset management subsidiaries for parent groups that are insurance companies or have a large insurance component.

Insurance companies' investment habits have changed significantly in recent years, impacted by the credit crunch starting in 2007. Stephen Haddrill, director general of the Association of British Insurers, highlighted this development in a March 2009 speech (Haddrill, 2009). He said that 10 years earlier the insurance industry had owned over 20 per cent of shares traded on the LSE, and held them for the long term, making corporate governance an important issue. Haddrill noted that by summer 2008, the insurance sector's share holdings had fallen to 15 per cent of the market, and shares had been replaced to an extent by bonds and property, a shift encouraged by stronger regulation of capital reserves, with the FSA requiring insurers to be robust against shocks to the stock market.

Pension funds

Pension funds invest regular pension contributions from individuals and employers into funds. Small pension schemes are managed by fund managers, but the larger ones may be self-administered.

The pension fund aims to make a high long-term return, to meet liabilities in the form of payouts to those receiving their pension, and if possible maintain a surplus. An actuary will advise the fund.

In the 1990s, pension funds were dogged by inadequate investment returns. Part of the reason was that companies had taken pension contribution holidays in the 1980s because stock markets were booming and the funds had been able to meet liabilities out of existing resources.

With changes to accounting standards, pension funds have been required to account for future liabilities on a current basis, which means that they must have assets to meet them. As a result of these pressures, some companies have closed schemes or increased contributions and, as with insurers, there has been some shift in investment from equities into bonds.

Sovereign wealth funds

Sovereign wealth funds (SWFs) are a sizeable class of investor. They are large pools of government-owned capital invested in foreign assets for the long term. IFSL found that the SWF industry had assets under management of US\$3.9 trillion in 2008, up 18 per cent on the previous year, but the growth rate is likely to slow over the next few years because of the recent sharp decline in commodity prices and the economic crisis (Maslakovic, 2009c: 1, 3, 7). Major SWFs have established representative offices in London. Among these is the UAE-based Abu Dhabi Investment Authority, which is the biggest SWF with US\$875 billion under management.

The SWF industry has been criticised for limited disclosure and transparency. According to the IFSL report, a set of 24 Generally Accepted Principles and Practices for SWFs published in October 2008, and further work that the International Monetary Fund and the Organisation for Economic Co-operation and Development are doing in the area, should bring more transparency to this market.

According to Buchanan Communications (2008), international governments have also expressed reservations that SWFs may invest to secure control of strategically important sectors for political reasons, and could potentially use the investments to advance their own national interests.

According to the IFSL report, since the start of the sub-prime crisis, SWFs have made substantial losses on over US\$60 billion invested in US, Swiss and UK banks. Since then, SWFs have moved some assets into local shares in an effort to revive these markets.

The future

With an increasing regulatory burden, stockbrokers and investment banks have less time than ever for retail investors unless they have large sums to invest. In general, this has led to a growth of execution-only brokers for the small investor. However, DIY stock market investing has not taken off in the United Kingdom as much as it has in the United States.

It is the institutional investors who splash the cash and on whom the investment industry lavishes its attention. Hadrill, in his March 2009 speech, pointed out that equities were increasingly held by hedge funds, which were not holding for the long term, and by non-UK funds, so there is a more diverse ownership than before.

Pooled investments

Introduction

This chapter is about pooled investments. We shall focus on investment funds, including unit trusts and open-ended investment companies, and on investment companies. We examine split capital investment companies and how venture capital trusts work, as well as real estate investment trusts. We also cover exchange-traded funds and hedge funds.

Investment funds

Investment funds are designed to maximise portfolio diversification. Investors may invest a lump sum or make regular monthly payments. They gain access to a professional managed fund with a wide range of assets, so diversifying risks and reducing dealing costs.

Investment funds cover both unit trusts and open-ended investment companies (OEICs). EU member states, including the United Kingdom, originally developed the OEICs to make cross-border investing easier. The concept was introduced to the United Kingdom in 1997.

An OEIC has some technical differences from a unit trust, and unlike the latter, is a legally constituted limited company. For practical purposes, the two products are identical for the end investor. Most funds are likely to become OEICs because this type of fund is more flexible than a unit trust, and can be marketed cross-border. Some OEICs are conversions from unit trusts.

Unit trusts and OEICs trade at prices derived from the net asset value and are open ended, meaning that the fund may create or redeem as many further units (for a unit trust) or shares (for an OEIC) as are required to meet investor demand. You can view any fund's track record over recent years, but

as the regulator-driven mantra goes, past performance is no guarantee for the future.

In the case of unit trusts, there are two different prices for the units in existence. The price at which you buy is the offer price, and the price at which you sell is the bid price. The buying price is generally more than the selling price, and the difference, known as the spread, incorporates any initial charges and dealing costs. The OEIC has a single price that is linked directly to the value of the fund's investments.

Income paid from an investment fund is net of income tax. Capital gains tax is payable on profits subject to the annual allowance (£10,100 for 2009–10). The trustee of a unit trust (the equivalent for an OEIC is a depository) is usually a large bank, and oversees the running of the fund. The trustee of a pension fund sets targets. In a unit trust the manager appoints the trustee, but in a pension fund, it is the trustee who appoints the manager.

Selection criteria

Risk profiles and management styles vary widely between investment funds, and so do their five-year track records. You can find details of a fund's track record in the magazines *Money Management* or *Money Observer*, or on a website focused on funds such as Trustnet (www.trustnet.com). For other useful sites, see Appendix 1 under the heading 'Collective investments and similar'. Let us now look at charges and investment strategies, both factors to be considered in fund selection.

Charges

An investment fund is likely to have an initial charge, also known as a front-end charge, part of which is the commission paid to the adviser or broker who sold you the fund. The charge varies. For a few funds, it will be as high as 6 per cent of money invested. On a unit trust, most of the bid–offer spread consists of the initial charge. The OEIC has a more transparent presentation based on its single price, and it separately itemises the initial charge on the transaction statement.

In addition, there is an annual management charge, typically between 0.75 and 2 per cent of the value of the investor's holding each year. Other fees are not part of the annual management charge. They cover administration, custody, audit and some legal expenses, including those for trustees and registrars, and are detailed in the annual report and accounts.

Total expense ratio

A useful figure to assess how the charges of a unit trust, OEIC or investment company (see below) comparison with similar funds is the total expense ratio

(TER). It is a single percentage figure showing fees as a proportion of a fund's assets. The TER reflects internal charges in a way that many find more useful than the widely quoted management charge, although it excludes commissions paid to brokers by fund managers.

Under simplified prospectus rules introduced in September 2005, the TER comparisons are like for like because the calculation is standardised. This affects all UCITS (Undertakings for the Collective Investment of Transferable Securities) funds, which are those marketable across the European Union and registered within each EU country. Other funds may calculate the TER by their own methods.

Investment strategies

An actively managed fund tries to beat the market. Value investing seeks to buy stocks that are cheap in relation to underlying assets. Growth investing seeks out stocks with good growth prospects.

Tracker funds aim not to beat the market, but simply to track a popular market index such as the FTSE-100. Investors buy tracker funds because they are slightly lower risk than actively managed equity funds. Trackers may vary in their investment return, even when they are based on the same index, due to differences in both the fee structure and the tracking method.

Multi-manager funds have a strategy of maximising diversification. The two main types are a *fund of funds*, where a manager invests in a variety of other investment funds, and a *manager-of-managers* scheme, where a number of fund managers are each given part of the fund to invest in the stock market, and which costs less because it instructs managers rather than investing in an existing fund. In either case, the fund's performance depends on the skill of the stock selectors.

Investment companies

An investment company is a quoted company that invests in other companies' shares. It pools money from investors, but unlike an investment fund, is not categorised as a collective investment scheme as defined by the Financial Services Authority (FSA). It may issue different types of shares and own subsidiaries.

Again unlike an investment fund, which expands and contracts in size according to demand, the investment company is a closed-ended fund, which means that it has a fixed number of shares in issue at any one time. For every buyer of an investment company share, there must be a seller. The trust can issue new shares, subject to shareholder approval, and it can keep its assets in cash.

In July 2009 there were 432 investment companies with assets of around £79.1 billion, made up of 292 conventional companies with total assets of £74.3 billion, 120 venture capital trusts with total assets of £2.2 billion, and 20 split-capital investment companies with total assets of £2.7 billion.

The share price of an investment company fluctuates with supply and demand and market movements, and according to the value of the net assets, which are total assets less total liabilities. This means an investment company can trade on either a discount or a premium to the net asset value (NAV) per share. The NAV per share is the value of the underlying assets, divided by the number of shares in issue. If the share price of an investment company is lower than the NAV per share, the company is said to be trading at a discount. If the share price is higher than the NAV per share, the investment company is said to be trading at a premium. Investment companies tend to trade at a discount, but it does vary between sectors and according to which sectors and investment companies are in vogue at a particular time.

On balance, investment companies are slightly riskier than investment funds because their discount or premium to net assets may vary and they are usually geared, although to varying levels. Gearing allows them to borrow money to make additional securities purchases, and although it will magnify the company's performance in a rising market, if markets fall losses can also be magnified. Unless the fund management is considered exceptional, the share price will tend to trade at a discount to net asset value.

Investment companies are less well known than their younger, open-ended cousins, but have a more adventurous image. Their unique characteristics and flexibility, including the closed-ended structure and freedom to gear up, can make them very attractive. They make up around 13 per cent of the FTSE-250 index, and can invest significantly in unquoted stocks, and so provide money for financing new ventures. They are owned about half by institutions and half by private investors.

Investors in an investment company who want to make a complaint may not have the same access to the Financial Ombudsman Service as investors in an investment fund. But they will have access if the company was purchased through a manager-sponsored wrapper product such as a savings scheme, pension or individual savings account (ISA), or through a financial adviser, in which case there is also access to the Financial Services Compensation Scheme (see Chapter 31).

Investment companies can be self-managed, but in most cases the company employs a manager, who is answerable to the trust's board of directors. Investment companies vary by the type of stocks in which they invest, and are split into various sectors. Some aim to generate high income while others go for

capital gain, or a combination of both. Some invest in large blue-chip companies and others in the riskier alternative of smaller companies. Also contributing to the risk profile is the geographical location: trusts that invest in emerging markets are more speculative than those that stick to Western Europe.

Any gains made by an investment company on shares are not subject to tax, but investors may be liable for capital gains if they should sell their shares in the trust, subject to their annual personal allowance, unless they are sheltered within an ISA, personal equity plan or personal pension.

Investment companies distribute dividends with a 10 per cent credit, so lower and basic-rate taxpayers have no further tax liability. Higher-rate taxpayers may have to account for further income tax.

Investment companies, unlike investment funds, do not have trustees or depositories. Instead, they have an independent board of directors to oversee the management of the investment company. In extreme cases, the board might choose to take the management contract elsewhere. Investment companies have the flexibility to do this because they are companies in their own right.

Most investment companies are accessible to investors through monthly savings schemes, for which the managers may reduce or waive dealing costs. They are sometimes promoted as a flexible way of investing, enabling investors to stop and restart contributions without penalty. Advertising of investment companies is allowed only in the case of wrapper products (such as ISA schemes), and investors gain from the cost savings. But there will be a stockbroker's commission on trades, and buyers must pay stamp duty.

Many investment companies have no initial charge, unlike investment funds, and the annual management fee tends to be lower, although this can depend on the sector. The spread is usually narrower than on investment funds, although it can be wider, depending on the number of market makers.

Because of gearing, the trusts outperform in rising markets and underperform when markets decline. Over the long term, due to the closed-ended structure, the impact of gearing and (on average), lower charges, investment companies have tended to outperform other forms of collective investment, but there is a wide variety of sectors and risk profiles.

Split-capital investment companies

A split-capital investment company is a type of investment company that has more than one class of share capital. Usually, one type of share is for income and receives all the income generated by the trust, and the other is for capital gain. The trust has a fixed lifespan, perhaps seven years, compared with the unlimited life of other investment companies. At the end of its life its remaining assets are distributed among shareholders.

In the bear market from March 2000, split-capital investment companies saw their share prices plunge. When one fund collapsed in value, others followed because a number were linked by cross-share holdings and the funds had high levels of debt. The FSA subsequently conducted its largest ever investigation into the split-capital trust sector, and in December 2004 agreed a final £194 million negotiated settlement with 18 out of 22 fund management groups under investigation, with no admission on their part.

The split-cap sector declined from 123 splits with a total value of £14.1 billion in December 2001 to 45 splits valued at £5.7 billion by the end of November 2006, and has since declined further to less than half that number.

In the aftermath of the split-cap scandal, the Treasury consulted on whether investment companies should be regulated as products by the FSA, but decided against it.

Venture capital trusts

Venture capital trusts (VCTs) are a form of investment company that invests in small growth companies and aims to make capital gains for investors. VCTs can also be an attractive, if sometimes perhaps irregular, source of income.

VCTs were launched in the United Kingdom in 2005 to encourage private investors to invest in high-risk, unlisted UK companies that need start-up, early stage or expansion capital. They can also invest in the AIM market. VCTs have a risky nature, but they offer significant tax breaks for private investors.

There is very little trading in the shares, and market makers may offer a wide spread. The annual charges tend to be higher than for conventional investment companies, partly because the funds are small and lack economies of scale, but also because of the heavy research that some VCT managers carry out into sometimes small, not very transparent companies. The VCT plans an exit from its investments through a stock market listing or a takeover.

Real-estate investment trusts

A real-estate investment trust (REIT) is a quoted company that conducts a property rental business. It does not pay corporation tax on rental income or capital gains tax from the rental business, and must distribute most of its earnings to shareholders.

The REIT was created in the United States in 1960. It has since been popular in Australia, Japan, Hong Kong, France and the Netherlands.

The UK regime for REITs started in January 2007. The attraction of the REIT for private investors is that it enables diversified property investment through a tradeable investment asset.

Exchange-traded funds

An exchange-traded fund (ETF) combines structural elements of a unit trust and an investment trust. You can buy an ETF on margin, and settle using the underlying shares instead of cash. Unlike with a unit trust, there are no set-up charges, and anybody completing a trade will immediately know at what price. The first ETF in the United Kingdom was launched in April 2000 and was called the iFTSE-100. The product had already existed for seven years in the United States.

The ETF trades like an ordinary share on the LSE. Each unit tracks the movement of an entire index or sector, which provides the full benefits of diversification through a single instrument. There are ETFs based on both equity and fixed-income indices. An ETF usually pays a dividend and its price tends to be at a small discount to net assets. The price can change at any time during stock market opening hours.

Like a unit trust, the ETF is open-ended, and can issue an unlimited number of units to meet demand. Because it is based offshore, there is no stamp duty on units purchased. You can technically sell it short, but there have sometimes been problems with borrowing stock to deliver.

There is a management charge on an ETF, typically paid out of the fund's income, which is often low, given that this is an index-tracking fund.

According to Financial Research Corporation, global inflows into exchange-traded funds reached US\$200 billion in 2008.

Hedge funds

A hedge fund is usually a specialist type of pooled investment that is free to invest in all financial instruments or markets, including high-risk instruments, and may employ a range of investment strategies involving the use of gearing (borrowings) and shorting (selling securities it does not own to profit from a falling market). It may be either an entrepreneurial start-up operation or part of a larger group. Funds of funds, which invest in a variety of hedge funds, provide diversification and possibly reduced risk, but not the same opportunities for outperformance.

The hedge fund is often structured as a limited partnership, and it has unregulated status, but its investments will not be promoted to the general public.

Many hedge funds are registered in the Cayman Islands where there is lighter regulation, but some funds prefer registration in Dublin or Luxembourg for European exposure. Some French banks, for instance, register hedge funds in Dublin because they know that French investors want a regulated jurisdiction.

The fund may be managed elsewhere. In Europe, funds are typically managed from London because of the commercial clout that derives from being

regulated by the FSA. London is the largest hedge fund management centre in Europe, and second in size only to the United States.

Hedge funds typically set up account facilities with the prime brokers owned by banks. The prime brokers are custodians of hedge fund assets, offering securities lending and financing services to hedge funds, enabling them to use leverage as well as technological support. They may help with consulting and regulatory compliance services. They provide operational support and introductions to investors. They typically deal with many hedge funds and so can benefit from economies of scale.

One of the main lessons for hedge funds from the Lehman Brothers collapse is that they are not using enough prime brokers to diversify risk.

There is fear of a systemic risk from hedge funds destabilising the economy, perhaps by all investing together in the same direction, or becoming too heavily geared. So far, it has not happened. However, this has been the subject of major concern at international policy level.

Hedge funds are reluctant to reveal their investment strategies because others may copy them, so influencing securities prices and undermining profitability. This can conceal fraud. The scandal surrounding the Madoff investment fund, although it is not technically about a hedge fund, has drawn attention to this risk.

EU legislation

Over the next few years, the EU Directive on Alternative Investment Fund Managers will have an impact on hedge funds. More than twice as many funds and hedge fund managers are based in London as in the rest of the European Union. By mid-2009, the draft directive had come under heated discussion after the Group of 20's focus on financial stability in 2009, and shortly before that, the unravelling of the Madoff fraud. These events, together with the financial crisis, turned global sentiment in favour of more stringent legislation. Many industry figures in London argue that hedge funds became scapegoats.

The United Kingdom sought amendments to the draft directive, but France and Germany resisted them, arguing that hedge funds had to be regulated to quash systemic risk. The directive would impose restrictions beyond the US proposals for regulating hedge funds, which are focused on registering funds and collecting information, with the main concern of markets being that such information should go only to the regulators.

Under the EU directive, fund managers would have to pre-clear funds with regulators before they market them, including across borders, and capital requirements would be higher than now, with banks holding the assets of the fund having greater legal responsibility. The pre-clearance process could slow down launches of new funds or strategic changes within existing funds. Funds

would have to keep assets with a EU bank, and could not use US prime brokers or banks in other jurisdictions. Non-EU funds selling to EU investors would be subject to home state regulations comparable with those imposed by the directive. Among other restrictions, funds would have to limit leverage.

Nobody disputes that the directive has been hastily put together. There have already been some amendments, including exceptions for managers that do not use leverage. In mid-2009, it seemed likely that the European Parliament and the Council of Ministers would introduce further amendments. The directive could come to pass in late 2010, followed by an 18-month transition period.

Money market funds

Money market funds are mutual funds investing in short-term debt instruments. This type of fund started in the United States in the 1970s, and the Securities & Exchange Commission (SEC) published regulations governing them in 1983. The funds came to offshore Europe in the 1980s, where there were no SEC regulations. They relied on credit ratings from rating agencies to provide reassurance. Most funds are in France, Luxembourg and Ireland, and the main users include insurance companies and pension funds.

The main aim of money market funds is to preserve capital, but they also seek liquidity and competitive, sector-related returns. Money market funds are not engaged in leverage and pay lower interest than other fixed-income investments such as bonds. The returns may not keep up with inflation. In compensation for the modest returns, investors have looked to money market funds to keep their money secure, but there is no government guarantee, and occasionally, as in the most recent financial crisis, there has been a major loss of liquidity or loss of some of the capital invested.

In September 2008, in the United States, money market funds saw an outflow not far short of US\$200 billion (£147 billion) in a week after a fund ‘broke the buck’ by offering a return lower than the cash invested. Reserve’s Primary Fund, the oldest money market fund, would return only 97 cents on the dollar.

The Larosière report on European Union financial markets supervision (2009), called for a common European Union definition of money market funds. In mid-2009, money market trade associations were asking regulators, including in the United Kingdom, to adopt a new European classification of money market funds after such funds in Europe suffered liquidity problems in the financial crisis. The proposed new European classification, endorsed by the board of the European Fund and Asset Management Association and members of the Institutional Money Market Funds Association, rested on a revised single category of

money market funds, and would initially exclude money market funds with up to €100 billion under management out of a European industry total of €1.3 trillion.

According to the proposals, there would be two types of fund, short-term and regular, defined in a way that limited the main risks to which the funds are exposed. These main risks are interest rate risk, credit and credit spread risk, and liquidity risk. All existing money market funds outside these two categories will be allowed to keep the money market fund label for a transitional period of three years.

The new classification would not ban, for example, asset-backed securities from the funds. There was a liquidity problem, and to avoid this recurring there would be strict definitions, but no stipulation that funds could not be involved with securities of a given type.

Analysts and research

Introduction

Analysts have a highly paid and often influential job. In this chapter we shall look at how they operate, and some of the challenges and conflicts they face. We focus on fundamental and technical analysis in turn. We look at the impact of the Spitzer settlement on research and investment banking. We shall then turn briefly to the role of strategists and of economists, including in the 2007–10 financial crisis.

Fundamental analysis

Analysts focus on the dynamics of particular markets, and make trading and investment recommendations. They build up an eclectic mix of analytical tools, which they use in combination with subconscious thinking. The underlying aim is to understand the discount rate curve, which represents the market's expectations for interest rates projected into the future. This curve determines the average annual return, or yield, on bonds and other financial instruments. The analyst attempts to make an informed guess as to how the curve will behave. The prices of all financial instruments are strongly influenced by this unseen curve, and all financial instruments trade around it, like gravity.

Pure expectation theory has it that the discount curve at the front end is an expression of projected rates from the Bank of England. The theory of market segmentation explains the longer end of the curve as reflecting interest rates focused on particular maturities. Such theories are never the full truth.

The sell-side analysts who focus on the stock market are the ones whose views are most likely to come to public attention, through media exposure. They work for stockbrokers and investment banks, and publish research that is widely

disseminated. These analysts have, since the 1970s, played an increasing part in the buying and selling process. It has long not been enough for them to produce research without speaking to clients, as they once did. The work of analysts today is of value for various banking activities, including investment banking, trading and sales. An analyst typically follows six or seven large companies in a sector and backs up the salespeople with their specialist research. Buy-side analysts, in contrast, work for large institutional investors and have a broader role, with less focus on individual stocks or sectors. Their research is internally disseminated.

Analysts' levels of skill and training vary. They may have worked in the industry they cover. On anecdotal evidence, less than a quarter of analysts are fully qualified accountants. Some entered the business from the industries they cover, and others as fresh graduates. A very few are ex-financial journalists. Whatever their background, they need to understand the numbers, write quickly and snappily, gain an in-depth knowledge of the companies they cover, and produce their own forecasts, as well as deal professionally with clients and colleagues internally.

Analysts forecast numbers widely used in the City such as earnings per share, P/E ratios and discounted cash flows (see Chapter 5), and perhaps some more obscure ratios. A company's basic figures may be culled from annual or half-year results. All listed companies in the European Union have used International Financial Reporting Standards (IFRS) (see Chapter 27) in their accounts since 1 January 2005, and this harmonisation enables comparability across Europe.

The Spitzer impact

The April 2003 Spitzer settlement in the United States arose because of the conflict of interests between research recommendations and investment banking within the same firm. Elliot Spitzer, then New York Attorney General, found that Henry Blodget, a Merrill Lynch internet company analyst, had in private e-mails disparaged an internet stock that the firm was otherwise recommending to clients. Spitzer found other instances of biased recommendations across the industry.

Ten leading global investment banks settled the matter with the Securities & Exchange Commission, the New York Stock Exchange, the National Association of Securities Dealers and Spitzer. As part of the redress, the banks agreed to amend their practices. They would physically separate research and investment banking departments to prevent the passing of information. Senior management would decide the research department's budget without input from investment banking. Research

analysts could no longer be compensated in a way that reflected investment banking revenues. Investment banking was to have no part in decisions on company coverage, and analysts were prohibited from participating in new business pitches and road shows. Each firm was to make its analysts' historical ratings and target forecasts publicly available. The firms entered into a voluntary agreement to restrict 'spinning' – the allocation of securities in hot initial public offerings (IPOs) to certain company executives and directors.

The scandal focused attention on a phenomenon that was hardly new. The cosy cooperation between research teams and corporate finance has worked in bull markets, but there is a tendency for it to be exposed when markets suffer a downturn. There is some feeling that the Spitzer settlement was politically motivated, and did not address the heart of the problem because it allowed banks to retain their business model.

However it was criticised, the Spitzer settlement has set an international agenda. On both sides of the Atlantic, investment banks and brokers have been forced to reorganise their working arrangements to ensure greater segregation between analysts and corporate financiers.

Even in today's regulatory climate, which is sensitive to conflicts of interests, pressure is on sell-side analysts to make *buy*, rather than *hold* or *sell*, recommendations on most stocks because they are scared of upsetting the underlying companies, some of which may be, or become, clients of their employer's lucrative investment banking division.

The companies in this way retain a whip hand over analysts, although there are a few maverick analysts who are not afraid to shout 'sell'. If listed companies give any individual analysts a selective briefing or lead, they could be in breach of the part of the Listing Rules, issued by the UK Listing Authority, part of the Financial Services Authority (FSA), which require price-sensitive information to be announced to the market without delay. To stick to the rules, companies dole out the same bland information to analysts. Sell-side analysts who stumble on new information, which is what fund managers really want to hear, may have problems communicating it to their clients.

Institutional investors know how to read between the lines, and perhaps glean something extra from a telephone conversation with an analyst. Publicly, fund managers rate analysts on their quality of research more than their forecasting record. But experience shows that an analyst who consistently makes

ludicrous forecasts will not be taken seriously, not least by salespeople within the analyst's bank.

There is a danger in that an analyst's report intended for securities professionals may get into the hands of private investors, who might take it too literally. By this stage too, it will probably be out of date. Research notes can need updating within hours or even minutes.

Technical analysis

Technical analysts may work independently or for large financial institutions, and are far fewer than their fundamental analyst counterparts. Their approach has a greater serious following in foreign exchange and commodities than in equities.

They aim to forecast future price and index movements based on past patterns. Technical analysis may or may not be accompanied by fundamental analysis, which focuses on company fundamentals and results.

The cornerstone of technical analysis is trend theory, which is rooted in the idea of crowd psychology. If the share price is rising, everyone tries to jump on the bandwagon, establishing an uptrend. On the same principle, panic selling can start a down trend. Technical analysts believe that the trend will stay in force until it is unequivocally broken.

Trend theory originated with Dow theory, which financial journalist Charles Dow started developing in the late 19th century after he noticed that stocks tended to rise or fall together. Dow theory says that the share price reflects *everything* that is known about a stock. There are three trends in the stock market – primary, secondary and tertiary – and they all operate simultaneously. Volume counts, but is a secondary consideration. Dow historians claim that the theory has an impressive track record. Critics say it is out of date and its signals come too late.

Chart patterns are based around trend theory, and incorporate the concepts of support and resistance. Resistance is the high point on a chart where investors will not buy further, so the price has stopped rising and sellers have emerged. The *support* level is where investors have stopped selling. The more a support or resistance line is tested, the more effective it is considered, and the movement can appear on charts in recurring patterns, categorised as continuation or reversal.

A *gap* takes the form of a physical break in share price movements, and is often a continuation pattern. The less frequently a gap arises, the more significant it is considered, particularly on a heavily traded stock. If trading volume rises with the gap, it strengthens the message.

Among continuation patterns, a *rectangle* is a pricing range where the price swings up to a resistance line, then down to a support line until breakout. The more often the share price touches these lines, the more reliable the pattern. The *flag*, another pattern, typically develops in less than three weeks. The *triangle* is

another continuation pattern. It consists of two lines that converge at an apex, one representing resistance and the other support.

Head and shoulders is the best-known reversal pattern, and is a bearish signal. The share price moves up and reverts to form the first shoulder, which is a peak in the trend. A sharp reaction will follow, and the share price dips to form a trough. It then rises to a higher peak, which becomes the head, and drops back again to form a second trough. The share price will rise once more, but can only form another shoulder before falling down and breaking the *support* level, which is known as the neckline.

The *double top* is another reversal pattern, which usually develops over some months. The share price rises and falls back, then returns to its old peak, or close to it, and reverts.

These and other patterns show how the dynamics of supply and demand play out. When either buyers or sellers get the upper hand, the line breaks out of the pattern. On an upside movement, trading volume tends to rise. If a breakout happens, technicians measure the full depth of the preceding pattern and project it as a minimum *from* the point of breakout. This is the target length of movement projected. Some technical analysts use the patterns to time trades and predict future price movements, while others are cynical.

After analysing price, volume and related trends, the analyst may use indicators that focus on, among other factors, whether the market is overbought or oversold, its relative performance and its rate of change. Many indicators are based around the moving average, which shows changes in the average share price over a given period. Others are based around volume. Technicians use cycles, which are based on regularly recurring price patterns within a specified period, to measure time.

Every technical analyst has favoured techniques, and some believe the simplest work best. However, the variations are limited only by the imagination of traders and analysts and, a cynic would say, of software manufacturers. The types of charts in use vary. For some, a line chart with its great detail, the most basic type of chart, may reassure, but others prefer to cut out the *noise* of intra-day share price movement and use a point and figure chart. Short-term traders are increasingly drawn to Japanese candlesticks, which are an exotic alternative to conventional bar charts. Computer software enables the technical analyst to switch from one chart type to another.

Technical analysis caters also for those who shun simplicity. William D Gann was a technician with a unique, highly mathematical form of technical analysis linking price and time proportionately, with lashings of special numbers and astrological inferences. How well it all works is open to controversy, and it certainly did not make Gann rich. Courses in Gann theory tend not to come cheap.

Elliott wave theory is another tough nut to crack. It finds that the market always rises in five waves and falls in three, and so assumes a perpetual long-term bull market. The proportional relationship of the waves is linked to Fibonacci numbers, which have a mathematical relationship claimed to be deep-rooted in nature.

Many equities professionals in the City regard technical analysis as a somewhat fringe activity, but others take it more seriously. Some say it should be one tool for investors, but not the only one.

Others

An *economist* generates value-added research on the functioning of the economy, and aims to interpret the actions of the Central Bank. A *strategist* sits between an analyst and an economist, and makes broad calls on various asset classes and markets.

All three of these professionals focus on trends in inflation, interest rates and currency movements. They understand that statistics are approximate but will require them to have been reliably sourced from a genuinely random sample, taking into account any unusual factors. Statistics from some countries may not be of the same kind, or quality, as from the United Kingdom.

Economists and the crisis

The 2007–10 financial crisis hammered the reputation of economists, most of whom had failed to foresee it. There is a widely held view that macroeconomists focused too much on curbing inflation and not enough on curbing asset bubbles, and this helped to cause the crisis. The standard models used by economists assume perfect capital markets, and this is wrong.

Economists operate in specialist areas where they do not often need broader perspectives. When economists make wrong predictions, it casts a shadow over their status, although the science is about more than forecasting, or indeed financial markets.

Since the crisis, the canon of economics has come under scrutiny. Eminent economists have taken to hurling insults at others, often of high standing. The most significant debate has been between the Keynesians, who advocate that every percentage point of government spending multiplies into a higher percentage of gross domestic product, and Ricardians, who believe that government spending translates into a lower percentage.

The Keynesian view holds sway in the United States but not, for example, in Germany.

In June 2009, Paul Krugman, a US Keynesian, and winner of the Nobel Memorial Prize in Economic Sciences in 2008, said that much of the previous 30 years of economics had been ‘spectacularly useless at best, and positively harmful at worst’.

The difference in views of macroeconomists has contributed to the diversity of policymaker reactions to the financial crisis. Economists sent a letter to Queen Elizabeth II after she asked, on a visit to the London School of Economics and Political Science (LSEPS) in November 2008, why nobody had anticipated the credit crunch. The letter, signed by LSEPS professor Tim Besley, a member of the Bank of England Monetary Policy Committee, and others, explained the ‘psychology of denial’ that had prevailed ahead of the crisis. The economists explained how with low interest rates and cheap borrowing, there had been a feelgood factor which concealed imbalances in the world economy. Some in the financial world had wrongly and arrogantly convinced themselves they had found ways to spread risk in financial markets. Everybody appeared to be doing their job properly, but collectively this led to imbalances that nobody saw or controlled.

With the benefit of hindsight, economists are tweaking their models and adding financial market analysis, and there is research into how incentives distort efficient markets.

Statistics are often presented in fractionalised detail, but this does not in itself mean they are precise. A set of numbers can be a first stab, which is later revised. For example, gross domestic output, a measure of a country’s economic output, is frequently revised, and should only be seen as a guide. Statistics such as the unemployment rate may be calculated in more than one way. Economists consider a collection of figures to get the broad picture.

A one-off figure could be a temporary blip. What counts is the trend. A rising gross domestic product (GDP) in a strong economy gives rise to inflation fears. If GDP rises by more than 3 per cent in each of four quarters in succession, the Bank of England will probably raise interest rates to restrain it.

How far it is possible to use macroeconomic statistics and events for forecasting the future is as open to question as the predictions of analysts and other professional forecasters.

Financial communications

Introduction

Public relations and investor relations specialists, investors and journalists are linked into chain flows of corporate news and information. It is on this basis that shares are often traded. In this chapter, we shall examine how the communications process works.

Public relations

Public relations (PR) agencies build the image of quoted companies to financial journalists, and insofar as they will listen, to analysts. In choosing a PR agency, companies look for a track record, knowledge of the sector and proven delivery of results. In the event of a crisis, the company wants minimum impact on the share price. If it gets its communication right, there could be a blip rather than a potential disaster.

Companies assess the impact of PR on the business, and not just the number of press cuttings. They use sophisticated measurement techniques. One insurance company, for example, knows it has its communication right when it delivers good results without provoking too many telephone calls from customers demanding a reduction in premiums on their policies.

Some companies hire an agency on a retainer as a failsafe. For most of the year the agency ticks away at a maintenance level, but if a crisis arises, it will seek to protect the company's public image. Even at 5.00 pm it will be ready to parachute a team in to help its client. Agencies represent companies during a takeover period, or for an initial public offering (IPO) (see Chapters 6 and 7). As

part of the process, the PR agencies have a major role in distributing company results, which are normally published in March and September (based on a 31 December year end).

In controlling information flow, PR professionals aim to stay invisible, never to snatch the glory of the client, and in particular, to keep concealed how far the agency controls the agenda of journalists. Signs of a PR agency's unseen hand are evident on a daily basis in the press. A handful of agencies are linked to all the main activity in the City, but there are rich pickings for other agencies in less high-profile businesses.

Truth is, most journalists are desperate for information fast, and over time, the press has become more dependent on PR executives, finding them more accessible and more willing to explain basics than company executives. The relationship between journalists and PR is symbiotic.

In the past, some PR agents have leaked price-sensitive information to the press with impunity. But regulations have tightened up, and under the market abuse regime, employees of PR agencies who do this may now be subject to civil or criminal action. In addition, the Takeover Panel has been known to censure PR agents for breaking the rules.

Black PR, where companies use the media to blacken each other's reputation, remains in use, however.

Large companies may have their own corporate affairs departments. These in-house operations can be well informed and staffed by people who have the ear of the directors, but some are not well backed internally, and according to one PR agency director, 'just don't get it'.

Investor relations

Investor relations (IR) is about how a quoted company liaises with present and prospective investors. Through IR, the company tries to gain a fair valuation for its shares to keep investors loyal and the shares liquid. In addition, IR keeps the market informed of price-sensitive information without resorting to selective disclosure, and provides capital market feedback to the board for its decision making.

To assist in its role, the in-house IR team often sits close to the finance department and it talks to analysts and investors. The corporate communications team, in contrast, sits close to the chief executive, and deals mainly with the press. 'Day to day, the IR officer will be updating analysts on their spreadsheets or helping investors to understand the company better, and will give strategic feedback to the company,' Claire Fargeot, IR director at Buchanan Communications, told me.

The IR officer may also have some contact with certain journalists, who require a deeper understanding in certain areas. For example, an IR officer will take many calls from investors and analysts in relation to a company's half-year results release, but also perhaps from some publications.

'Most journalists do not have the time or patience to battle through the finer points on a half-year release – unless, of course, the company has been part of some media issue and the journalists want to get to the bottom of the story,' says Fargeot. 'The IR officer will be answering more specialist questions like, "Why have you made such a provision for the pension deficit?"'

The IR business has as much to do with private as with institutional investors, but according to Fargeot, treatment of retail customers varies significantly between customers. 'The only decider is bang for buck and private investors tend to be smaller investors, so they unfortunately also tend to get marginalised.'

Fargeot says that the real value of IR is downside limitation, for example during a hostile takeover bid and for corporate reputation protection. 'If a company is performing well with a solid strategy, is perceived as an interesting investment proposition and has an appreciated management team, the share price should do well. IR adds value when all these positive elements are in place, but the share price does not perform as expected.'

IR adds even more value when there is bad news to be disseminated or a sudden lack of confidence in the stock. The IR officer then reinforces the company's relationships with a loyal base of investors, or seeks out new investors to come on board and support the share price. IR can be useful in good times, but it will be much less visible. The measurement metrics can be as unscientific as counting how many investors turned up for a given shareholder meeting.

Fargeot says that companies tend to outsource IR when they are either resource restrained or in trouble. 'Most financial directors do a large amount of IR work, but smaller companies in particular may have no extra resource to help in this area, so they would buy in the support they need.'

Large companies buy in IR services to obtain some independent feedback, or services that they are not currently receiving from their corporate broker. 'An IR agency gives the company unbiased feedback, while the corporate broker will tend to tell it only what it wants to hear,' says Fargeot.

Some companies spend nothing on IR except the management team's time and the publication of the annual report and accounts. Some spend £100,000 or more on the annual report alone. International companies may have teams of 6 to 12 IR people dotted around the globe, but some companies have only a time-stretched financial director to handle all the IR.

As the legislative burden on companies is growing, so are the responsibilities of IR officers and their role as the interface between the company and the

investing marketplace. Not all companies take IR as seriously as they should, and even some FTSE-100 companies fail to pay attention to areas that IR feedback suggests is important for investors and analysts.

This can have repercussions. 'Most shareholders have no issue with voicing concerns if a company's IR activities are not hitting the mark, and IR officers are now being sacked for poor performance, just like CEOs,' says Fargeot. So far the IR officer, like the PR executive, is not regulated by the Financial Services Authority (FSA), but some believe that, in both cases, it is only a matter of time. Buchanan Communications makes more information about IR available on its website, with some interesting downloads, at www.buchanan.uk.com.

Corporate information flow

The London Stock Exchange Regulatory News Service (RNS) is one of several primary information providers (PIPs) which the FSA has approved to disseminate regulatory information to the market. A PIP sends out company announcements through secondary information providers, such as Reuters and Bloomberg.

If the news comes on a Saturday, it must still be disclosed, via press and news wires. At any meeting, however public, at which inside information is let out, there must be a prior or immediate announcement to ensure that the public has the same information. The listed company must make a judgement on what information needs to be disclosed and when.

Companies must disclose related-party transactions, for example by directors, and significant transactions, both of which require shareholder approval. To keep the market informed about the likely end-of-year results and to avoid a false market, companies may put out announcements on a more regular basis than is strictly required. The information disclosed should be complete.

Companies may delay disclosure of inside information if it is kept confidential and the non-disclosure does not mislead the market. This may be acceptable in negotiating mergers and acquisitions, where premature disclosure can scare away a party and prevent a deal from happening.

Companies send out releases providing news via a PIP, as a conventional way to inform the market. They may also send releases directly to investors, analysts and journalists, and perhaps publish them on their website simultaneously.

Journalists

A good story is said to be one that somebody does not want you to print. But financial journalists, particularly on daily newspapers, often have little time to

investigate and probe. Journalists may rely heavily on PR input, including provision of news releases, and if they are lucky, free press trips to interesting places and events. The adage that you cannot bribe the British journalist may be true, but financial institutions know they can sometimes soften them up.

Journalists take the basic information in a news release and any information they can muster, often directly from PR people, and use it to write their own piece. Some use chunks of news releases verbatim. The press release may be slanted. If a company's sales are up but its profits are down, the press release will probably emphasise the first statistic. If net profits are down but pre-tax profits are up, the release will focus on the latter.

Journalists tend to be suspicious of PR agencies, but not all of them see through the angle. Some are arts graduates without any specialist business education, and may be hampered by a lack of in-depth understanding of economics, finance and company accounting. Others, particularly on national newspapers, know their subject well and are highly respected for their professionalism.

Part of this professionalism may involve tapping sources who peddle only one side of the story and running with it in the newspaper, although later it may become clear that this is only half the story and that the source had an ulterior motive for providing it.

The most superficial news, but also the fastest, is published by the news agencies, which are wholesalers of news. Such real-time financial news reporting is exciting work, but the demands on journalists are gruelling. They must obtain quotes quickly from experts, and rework source material to present their news reports. The agencies provide news on a collective basis. A journalist who is bylined (that is, credited with a story) might have lifted whole paragraphs from stories of other journalists published earlier by the agency.

The journalists who work in some of these institutions are often young, bright and enthusiastic, but ignorant about markets. Many of them burn out after a few years and move on, sometimes into other trades and professions.

The other end of the spectrum is investigative journalism. The type of journalist who does this work is a rare breed, who probes rather than accepts, takes pride in uncovering scandals, and is not afraid to make enemies. Such journalists tend to be loners and may work as freelancers.

Even the best journalism has limitations. Dr Lynn Drennan, previous head of Division of Risk at Glasgow Caledonian University, has said on the conference circuit that the press will highlight any perceived infringement or corporate failure, and this will instil an apparent desire to place the blame on an individual or individuals, disguising the broader culpability of the organisation. She gave as examples the press treatment of Jeff Skilling, chief executive of Enron, in

2001; Robert Maxwell, chairman and chief executive of Mirror Group Newspapers when his pension theft hit the press; and Nick Leeson, the trader on the Singapore Monetary Exchange for Barings Bank. In a 2004 article in the *Journal of Business Ethics*, Drennan said there was nothing intrinsically new about the reasons behind the collapse of Enron and WorldCom, and nor had there been anything fresh in the media's desire to identify a scapegoat.

A good story is everything. Martin Fridson, a managing director at Merrill Lynch, said in his book *Investment Illusions* (1993: 124–25) that reporters have a tendency to approach not necessarily the best authorities, but those who can provide colourful quotes.

But if the press is not perfect, it is for private investors the least slanted source of City information, and, in the United Kingdom, continental Europe and the United States, it tends to be far more impartial than in some less developed countries. Michael Walters, former deputy City editor of the Daily Mail, wrote in *How to Profit from the Coming Share Boom* (1992) that financial journalists were important to investors: 'They may be ignorant, careless and easily fooled. But they are the only genuinely independent source of advice most people can get. Most other sources of advice have a financial interest in the advice they give. So stick with the press. It may be better than you think.'

How far the press reflects City opinion in a rising or falling market, and how far it dictates perceptions, is a matter of debate. The FSA has said that journalistic coverage of how it regulates the City can have significant impact.

Financial news on the internet

If a publication can identify a niche market with deep pockets for timely information, news or comment, journalism can be very profitable. Specialist publications in industries such as insurance, risk management, securitisation and derivatives are aimed at a narrow audience willing and able to pay highly for information that helps their business.

A successful venture of this kind is breakingviews.com, which sells niche comment on events in financial markets to investment banks and others. Hugo Dixon, a former journalist on the *Financial Times* Lex column, founded the service in 1999, and in 2009 sold it to Thomson Reuters for about £13 million.

Many trade publications charge for web content and many consumer publications do not, but there is no rule. In some cases, there is a charge

for premium content only. Blogs and message boards, podcasts and video interviews may be available free to registered website users.

Web-based financial journalism is often free of charge. This includes most national newspapers, the *Economist* and the BBC. The free sites have not attracted as much advertising as most had expected in the early days of the internet, however. YouTube makes available many videos, including financial news and analysis, online for free use without registration. There is much distribution of news bites through Twitter, the free micro-blogging and social networking service.

Two national newspapers charge for business news content, and both have specialist corporate audiences that are willing to pay for this. The *Financial Times* website, FT.com, has a successful charging structure which applies to readers of more than a minimum number of articles, and the *Wall Street Journal* website charges subscribers.

In August 2009 Rupert Murdoch, who owns the *Wall Street Journal*, said that by June 2010, all his newspaper websites would be charging for content. Many in the industry are not convinced this would work, but if it proved to work for some, others would no doubt follow suit.

Tipsters

Many tip sheets and financial websites pride themselves as being contrarian, but that can translate into being off the rails. Individual share tipsters invariably make some poor recommendations, but can still be influential. A trick of the trade is to lift their tips from secondary sources, rewriting them in their own words to make the whole idea appear original. A poor track record can be glossed over, but the pages of the tip sheet must always be filled.

If a tipster wants to keep their reputation intact, it may pay to not be associated with one website or newsletter for too long. This way, their individual tipping record might never come properly under scrutiny. As an alternative strategy, many tipsters operate anonymously.

It is perhaps the boldest of the tipsters who are out to make their name. They may boast City experience, but this does not in itself rubber-stamp their investment advice. The old adage applies, if they know so much about stock-picking, why are they not investing their own money for a living? Many tipsters have never invested directly in shares in their lives.

Showmanship is part of the box of tricks. One of the all-time masters was US tipster Joseph Granville who, in his heyday, spoke to investors with his chimpanzee

and a few bikini-clad models in tow. He would wear blinking bow ties and play the piano or dress up as a chicken. He once dropped his trousers to read stock quotes in his shorts. He had been known to dress like Moses and deliver the '10 commandments' of investing, and had purportedly walked on water.

When a small-company tip is given prominence in a popular newspaper, the market makers increase the price. Other tipsters get wind of this and steal the idea. It is a spiral that can send up the share price all too briefly and temporarily. Another big source of share tips is internet bulletin boards. They are notoriously unreliable. Many who post on the internet have an ulterior motive. Their output, perhaps under several aliases, may slip untruths amidst a plethora of facts. Recently, the chief executive of a company criticised anonymously on the message boards tracked down the writer and sued him, which led to a settlement. But writers who contribute to bulletin boards from internet cafés have avoided identification.

In today's regulatory environment, it is at least frowned on for a tipster to hold shares in a company that they recommend, but it happens. If the tipster buys through nominee holdings, or through a friend, in small amounts, it can be hard to detect.

In a landmark case, in 1999 and 2000 *Daily Mirror* journalists Anil Bhoyrul and James Hipwell made profits from the process of buying shares before tipping them in the 'City Slickers' column of their newspaper, and subsequently selling them after the price rose. In 2000, the Press Complaints Commission (PCC) ruled on the case. The two journalists were dismissed for gross misconduct, including breaches of the parts of the PCC's Code of Practice applicable to financial journalists. Later the Department of Trade and Industry started a criminal investigation into their activities. A criminal prosecution was brought for market manipulation, in breach of the Financial Services Act 1986, applicable at the time. In early 2006 one of the Slickers, James Hipwell, who denied misleading the market, was jailed for six months. The other, Anil Bhoyrul, who had pleaded guilty, had received a 180-hour community service order. Terry Shepherd, a private investor, was sentenced to three months after having helped the Slickers by publishing advance notice of their tips on the internet bulletin boards.

If such a case were to arise now, the FSA itself could take enforcement action for market abuse. But criminal lawyers see this as unlikely because of the difficulty of proving the case.

Financial promotions

Discussion of the press would not be complete without reference to financial services advertising. The FSA focuses on financial services adverts likely to

have a major risk impact on consumers, and it has fined some firms for misleading promotions.

The credit crisis

There has been some investigation into whether financial journalism exacerbated the 2007–10 financial crisis. In early 2009, the UK Treasury Committee examined the role of the media in the banking crisis, and whether journalists should operate under any sort of reporting restrictions over the period.

Unsurprisingly, the news media was unanimously opposed to such restrictions. Part of its case was that more aggressive regulation would increase the authority of unregulated sites such as financial bulletins and chat rooms, which would be disastrous for the investing public. Some said that to impose restrictions on what mainstream media could cover would lead to public uncertainty, and that the financial media, by making information available to all the public simultaneously, contributed to the proper functioning of the financial markets.

A study by Polis, a media think tank at the London School of Economics and Political Science (Tambini, 2008), said that financial journalism needs an overhaul to meet the demands of reporting modern markets and the financial system. The study queried whether journalistic privileges should apply to, for example, bloggers.

UK financial services regulation

Introduction

In this chapter, we shall examine how financial services regulation has developed in the United Kingdom, and how the Financial Services Authority (FSA) operates. We conclude with a glimpse into the potential future, including the opposition Conservative Party's plans to overhaul the regulatory regime.

Please read this chapter in conjunction with Chapter 23, which focuses on European and global financial services regulation. These will have a major impact on the UK position.

Overview

Financial services regulation has raised its profile since the financial crisis started in 2007, and it now appears stricter and better resourced. Time will tell how deep-rooted is this trend, but it is clear that it is rooted in failure. In this country, regulation is vested in a single body, the FSA, which is part of the Tripartite Authority, along with HM Treasury and the Bank of England. The system failed in many areas, including in addressing the Northern Rock problems early enough. As a broad generalisation, the UK regulator and other authorities, like those in the financial services industry, have put some faith in efficient markets, meaning that markets can sort out their own mess and so intervention should only be a last resort, and this has now been proven wrong. The efficient markets theory has come under new scrutiny.

The FSA is willing to debate the issues but it has a practical job of regulation. It does not have a free hand but, for instance, has to commit substantial

resources to implementing EU legislation. Since the crisis, the motivation and integrity of regulators and the structure of their organisations have come under review. The scrutiny was not always so intense. Until the Financial Services Act 1986, the City had informal regulation.

The Financial Services Act

Margaret Thatcher, made prime minister in 1979, took the position that if London was to stay Europe's leading financial services centre, it had to lead by regulation. Her government commissioned Jim Gower, a university professor, to prepare proposals to regulate the UK financial services industry, and these led to the Financial Services Act 1986, implemented in February 1988.

The Act created self-regulation within a statutory framework for the financial services industry. Firms and their key staff were required to obtain approval from the regulators as a condition of running their business. The Securities & Investment Board (SIB) oversaw the self-regulatory organisations (SROs), which created rules for, policed and controlled authorised firms. Their authority was statutory in all but name.

Meanwhile, legislative changes extended across financial sectors. The Insurance Companies Act 1982 was introduced to regulate general insurance companies. The Building Societies Act 1986 was intended to make building societies more competitive.

Deficiencies started to emerge. The spread of responsibilities among regulators for supervising financial conglomerates operating across asset classes and jurisdictions was not always clear, and could mean a lack of action. This was why Barings was inadequately supervised ahead of its collapse (see Chapter 2).

The Financial Services Authority

The FSA gained its powers and responsibilities at midnight on 30 November 2001, when the Financial Services and Markets Act 2000 (FSMA) came into force. The legislation incorporated 433 sections with 22 schedules, and was the first to have ever straddled two parliamentary sessions. Unlike before, there was direct statutory regulation, which put much more emphasis on protecting consumers.

At this point, the FSA became the single UK regulator for investment banking and insurance, as it is today, with responsibilities extending further across financial services. The FSA recognises exchanges and clearing houses, and regulates the United Kingdom's central securities depository. In 2002 it started to regulate credit unions, and two years later mortgage advisers. Since

January 2005, its regulation of the insurance industry has included brokers in the wholesale market. The regulator considers that wholesale parties need less protection than consumers.

The financial services industry funds its own regulation. The FSA receives no funding from the taxpayer but its budget is met from a levy on the firms it regulates. The amount each firm pays is determined according to its size and the types of business it undertakes. When financial penalties are imposed on firms or individuals, the proceeds are used to reduce fees in the following financial year. The regulator's budget for 2008/09 was £323 million. Europe Economics measured the impact of regulation on firms in 2003 research, where it found that the sample median incremental compliance costs incurred by firms was 1.6 per cent of non-regulatory operating costs.

As regulator, the FSA has four statutory objectives: (1) to maintain confidence in the UK financial system; (2) to promote public understanding of it; (3) to secure an appropriate degree of protection for consumers; and (4) to reduce the scope for financial crime.

The FSA authorises firms across the financial services industry, and approves individuals in key roles who work in it. Any firm undertaking regulated activity in the United Kingdom must be either FSA-authorized or exempt. Like the SROs before it, the FSA has the power to withdraw approval from an individual that it considers not fit and proper to perform the controlled function to which the approval relates. It may impose a prohibition order which prevents any person from involvement in financial services activity, and anybody who breaches such an order is committing a criminal offence. The FSA can apply for an injunction against any person or firm to prevent them from committing regulatory breaches.

More broadly, the FSA has the power to write rules and principles, codes and provisions. It is a private company, but it has statutory immunity from being sued from action taken in its official duties. The FSA is accountable both to a committee of non-executive members and to consumer and practitioner panels.

Once a year, the FSA must report to HM Treasury on how it has carried out its functions, and must hold a public meeting. The Treasury has the power to commission an inquiry into the regulator's operations, or a report on, for instance, a regulatory scandal. The Director General of Fair Trading may issue a report on any practice that it considers anti-competitive.

Before it implements regulation, the FSA consults with the industry and other parties. The regulator has a risk-based and proportionate approach, focusing more on the problems that are the biggest threat to its statutory objectives and on the largest firms. In practice the regulator often also moves against smaller firms, sometimes for minor breaches of regulation. Cynics observe that

these are the easier targets. In companies outside the financial services industry, the FSA has found it much harder to move against senior managers who are outside its regulatory regime, in cases of market abuse, for example.

The regulator encourages industry cooperation. If a firm settles early with the FSA, it will receive a discount on its penalty. Firms subject to FSA enforcement action routinely settle early, which saves work all round, but as lawyers have pointed out, it could be making the regulator's enforcement staff complacent.

If a firm is not satisfied with a disciplinary action of the FSA, it may refer the matter to the Financial Services and Markets Tribunal, run by the Lord Chancellor's department, which rehears the case. The tribunal has demonstrated in earlier hearings that it takes an independent approach.

Like any institution, the FSA is as good as the people it employs. To work at the regulator has always had cachet. Secondments both to and from the industry are commonplace. Lower salaries have been an obstacle to people moving from the private sector, but the FSA has nonetheless made some high-profile appointments from the industry, including Hector Sants, now the regulator's CEO. In 2009, the FSA increased its staff bonus payments by an overall 40 per cent year on year to £19.7 million. As many as 174 FSA staff were paid at least £100,000, while making an average bonus of £22,845. These levels are not, of course, as much as high-flying bankers earn, but neither are they negligible.

Insider dealing is the unstoppable crime

Insider dealing is probably an unstoppable phenomenon, according to recent research by Meziane Lasfer, professor of finance at Cass Business School, with Piotr Korczak and Adriana Korczak from Bristol University (Korczak, Korczak and Lasfer, 2010). The UK-based research, which took place over a six-year period, suggested that corporate insiders were perpetrating strategic insider dealing, and that they were mostly successful in avoiding enforcement action.

Lasfer's research focused on trading by executive and non-executive directors (but not institutions), within 30 days before news was announced, so every trade was in breach of the Model Code, which is a code of conduct aiming to stop directors or employees of listed companies from abusing unpublished price-sensitive information, particularly just before results announcements.

The work was based on all regulatory news releases by FTSE All Share firms published in the RNS (Regulatory News Service) between January 1999 and December 2002. There were 119,179 announcements,

of which 78,251 were non-compounding news items, on all of which corporate insiders had traded within the forbidden 30-day period. The research examined 8,086 open-market directors' trades in the sample three-year period from January 1999 to December 2002. The trading was on good news and on bad news, in categories that encompassed earnings, other results and dividends, capital structure, restructuring (including mergers and acquisitions activity), ownership, board changes, general business information and miscellaneous.

According to Lasfer, given the size of the sample, there has to be some insider trading here although, as he stressed, in most cases this was not conclusive or the FSA would have taken action on these cases. His conclusion was based rather on a reasonable assumption. The FSA monitors markets more broadly for abnormal pre-announcement price movements around merger and acquisitions announcements, trading updates and similar events, and noted in 2006 (FSA, 2006a: 4) that insider trading might have taken place before about one-third of takeover announcements in 2004.

Lasfer said that overall the trading was strategic, which limited the likelihood of being caught. He noted that 50 per cent of trades were one-way, and 50 per cent involved successive buying and selling. Traders will buy some shares and sell others, and so end up with a desired net amount. The higher the impact of the news, the lower is the probability that they will trade. He noted that insiders traded more on good than on bad news, and that the trading on both bad and good news was more prevalent in large companies.

Lasfer is uncertain whether letting parties trade on insider information would harm the City's reputation more than taking them to court. He noted that insider trading meant a transfer of funds from people who did not have information to those who did, which increased market efficiency, but had the downside that people would not trust the market, as had happened in some emerging markets.

The academic literature is divided on the pros and cons of insider dealing, but the FSA necessarily takes a practical stance. The UK regulator has a clear mandate to tackle insider dealing, which directly impacts upon two of its statutory objectives – to reduce financial crime and to maintain confidence in the financial system by ensuring clean, efficient and orderly markets. It has the power to bring civil action for market abuse, and as an alternative course of action which requires a higher level of proof, to prosecute market manipulation as a criminal case under the FSMA.

The FSA seeks to change behaviour so that making a quick buck out of confidential information is seen as cheating, socially unacceptable, and most importantly, a serious crime for which one can go to prison. The regulator notes that one way to change behaviour is by making examples of wrongdoers, by publicly demonstrating that crime does not pay, and that where a crime has been committed, the evidence supports a prosecution and the public interest test is engaged, it will prosecute.

In 2009, the government announced proposals to give the FSA new statutory powers to grant immunity when investigating criminal cases such as insider dealing. The FSA has said this would help it by providing protection to witnesses who agree to cooperate with the FSA in cases where the misconduct has been carried out by two or more persons acting in concert, and they are prepared to give evidence to secure the conviction of others involved. As this book went to press, the FSA was consulting on increasing financial penalties, with a proposed minimum fine in market abuse cases of £100,000.

All this may help deterrence. A 2002 study by Bhattacharya and Daouk, 'The World Price of Insider Trading', suggests that enforcement rather than the existence of rules alone is needed for regulation to improve market cleanliness.

There is some way to go. So far the FSA has had limited success in bringing actions against insider dealing, in proportion to the amount that could be going on, but it has succeeded in creating fear that it will crack down on such incidents. More resources would clearly help the FSA in its cases, including getting recorded information, e-mail flow and similar, and also with hiring top lawyers.

The FSA in transition

The FSA, more than other regulators across the globe, has sought to regulate the financial services industry through broad principles, although it also has rules. The principles enable it to present a case more easily against firms than if it relied only on rules, where lawyers could find loopholes.

The FSA gives firms a steer on how to interpret the principles, but this is not always done through official channels. This puts pressure on the industry to listen to what FSA representatives say at conferences, or via press interviews, or in 'Dear CEO' letters sent out to firms. This regime came under intensified scrutiny after the regulator had clearly, and on its own admission, failed to regulate banks effectively in the run-up to the financial crisis.

In a March 2009 speech at a *Reuters* Newsmaker event, Hector Sants said that it was ‘illusory’ to suggest that the FSA could operate on principles alone, and that the policymaking framework did not allow it (Sants, 2009). He said that Europe had a particular penchant for rules, and that a principles-based approach did not work with individuals who had no principles.

Sants said that the FSA needed to subscribe to a philosophy of judging firms on the outcomes of their action and not on compliance with an individual rule, and that a better strapline than principles-based regulation was ‘outcomes-focused’. The FSA was not jettisoning, but adapting, its historical approach.

In the same month the FSA published the Turner Review, produced by Adair Turner, chairman of the regulator (Turner, 2009a), in response to a request from the chancellor to review events leading to the financial crisis and to enact reform. The report recommended stronger guidance on business models and products, counter-cyclical capital requirements so banks would set money aside in good times in preparation for bad times, and more emphasis on risk management.

In addition, the Turner Review called for creation of a new European institution as an independent authority with regulatory powers, a standard setter and overseer in the area of supervision, which would be significantly involved in macro-prudential analysis. Supervision of individual firms should continue to be performed at national level.

This is the direction in which financial services regulation is moving. By late 2009, the FSA had already started intensive supervision. This was a shift from ‘light-touch’ regulation, a previous mantra, into a more intrusive approach. The FSA had long made it clear that it would hold senior management responsible from problems in firms, which helped to inculcate in them a compliance culture from the top. As part of the new approach, the regulator challenges areas it had previously left alone, including accounting decisions and business models, and it judges the judgement of managers. The FSA has proposed that fines could treble in size, and it has discussed credible deterrence; it has said that people should be frightened of the regulator.

The FSA, like other parts of the regulatory regime, is focused on systemic risk. As yet, there is no definition of systemic significance. In a speech at the Turner Review conference, Lord Turner (2009b) pointed to size and interconnectedness, noting that the more banks were linked by counterparty relationships and interbank funding, the greater the danger that the failure of one would pull down the system.

Linked to systemic risk is the current regulatory focus, by the FSA and others, on ‘living wills’, a term referring to resolution recovery plans set out in advance by systemically important financial institutions. The idea will be to de-risk going concerns which should be maintained as such wherever possible,

or to provide a resolution plan when the firm needed to be wound down. Given that firms have cross-border flows, this has given rise to such issues as conflicts between the insolvency laws of different countries, and financial burden-sharing between countries.

One of the fears around living wills is that they will not easily resolve the problem of moral hazard, which is where parties covered against the adverse consequences of risk may be more reckless than they would otherwise be because they know they are protected. If an execution mechanism for resolution is made easier, it does not facilitate the decision whether to close the firm or not, and if this is done, counterparties and creditors may be hit hard. One idea that has been suggested is to have national subsidiaries of banks, with restricted lending to other parts of the group. This could have adverse consequences on group liquidity, and besides, it does not address public demand for bailing out the deposit-taking part of a large bank. This could be addressed by ring fencing this part, in a Glass–Steagall-style separation (see Chapter 3).

The Turner Review and the government white paper are opposed to an absolute split between retail and investment banking, but the Conservatives, the Bank of England, and the Liberal Democrats are more open to such drastic reform.

The future

The government has set out plans to enhance the current regulatory structure, based around the FSA, which was its creation, in the white paper *Reforming Financial Markets* (HM Treasury, 2009a). In this paper it admitted that the authorities had made errors before the financial crisis, and announced proposals, aligned with those in the Turner Review, to set up a super-regulator called the Council for Financial Stability, bringing the Treasury, the FSA and the Bank of England together regularly to discuss whether to impose stricter requirements on banks. The same authorities would be involved as in the Tripartite Authority, created in 1997, but there would be more transparency, with minutes to the meetings published, and the Council would have to answer to Parliament.

Under the Labour plan, the FSA would be responsible for setting higher capital requirements and lower leverage ratios, and be able to veto remuneration packages. There would be stronger bank boards, and non-executive directors would have to monitor risks more carefully. The banks would fund a national money advice line, and there would be a stronger deposit protection scheme. The FSA would have powers to deal with financial emergencies. The paper highlighted the need for an international banking regulatory mechanism.

In the same month, the Conservative Party published an alternative white paper, *From Crisis to Confidence: Plan for sound banking* (2009), in which it criticised the government proposals and announced sweeping changes, which would be implemented should it be elected to power. The Conservatives proposed to abolish the FSA and the tripartite system and give the Bank of England new powers.

This vision of future regulation is likely to happen if the Conservatives get into power, and it would undoubtedly be radical. The Conservative paper argued that the tripartite regulatory system was based on a false premise that it was possible to separate monetary policy in one institution and the regulation of banks' balance sheets through which monetary policy operates in another. The limited focus of the Bank of England was compounded by the FSA's narrow regulatory approach, where prudential supervision of banking risks was downgraded in favour of regulation of how banks went about their business, resulting in a box-ticking approach to ensuring compliance with detailed rules. As a result of this approach, it claimed, the FSA had failed to detect or prevent a dangerous build-up of risk throughout the banking system, and when the crisis broke, the run on Northern Rock exposed a failure of coordination between the tripartite authorities and a lack of effective procedures for dealing with failing banks.

According to the alternative white paper, the Conservatives would make the Bank of England responsible for macro-prudential regulation, creating a new financial policy committee within the bank, which would monitor systemic risks and operate new macro-prudential regulatory tools. In addition, the Bank of England would become responsible for the micro-prudential regulation of all banks, building societies and other significant institutions, including insurance companies. It would do this through a new financial regulation division, whose work would be overseen by the financial policy committee to ensure close coordination between macro-prudential and micro-prudential regulation.

The Conservatives would create a new Consumer Protection Agency (CPA) which would have responsibility for protecting consumers, as well as conducting business regulation and supervision. The CPA would conduct prudential regulation of firms that are not systemically important, such as insurance, investment and mortgage intermediaries.

The danger of excessive regulation

The industry has issued warnings about the dangers of excessive regulation. There is widespread feeling that more regulation may not be the answer, not least because extraregulatory solutions such as government bailouts have sometimes proved the only way forward. Anthony Belchambers, CEO of the Futures and Options Association, noted (2009) that the depth of commitment by regulatory authorities and governments was in some cases questionable, with the

approaches to hedge funds and OTC derivatives being cases in point. He noted a populist tendency to blame the crisis on the investment banking model, when the problem was rather the excess to which elements of it were taken.

There are not many who would do away with regulation altogether, despite its flaws and its failure to address the crisis. In a November 2009 think piece Karl Snowden, chairman of the Financial Advice Academy, commentator and consultant, said that regulation had flaws in that rules challenge people to avoid them; regulation engenders a false sense of security; regulation distorts markets, smothers innovation and restricts competition; and regulators are human and can only regulate what they understand. He said that regulation of financial services was needed but it should take account of these weaknesses, building on the three pillars of clarity, consistency and certainty. Regulators should be clear what they want; they should be consistent in avoiding gaps and arbitrage across borders, or within a sector, avoiding conflicting overlaps in regulatory outcomes; and companies and consumers need a regulatory regime where they can be certain of the consequences of their actions.

In a May 2009 Institute of Economic Affairs (IEA) panel discussion, Geoffrey Wood, professor of economics at Cass Business School, said that in the 19th century, shareholders had a lot of liability and had to put up more money if a firm got into trouble, and that this system could work today (IEA, 2009). Philip Booth, a professor at Cass Business School and editorial and programme director at the IEA, said that regulators, like the market, could be persuaded by latest fads and that regulation should have a narrow remit, based on detailed principles of law. He said there was no evidence that unregulated activity, such as tax havens and hedge funds, had caused problems.

Booth's suggestions are diametrically opposed to those of regulatory regimes, which have sought to broaden their reach. In a 9 November 2009 speech at Bloomberg, Hector Sants said that it was important to recognise that there were limits to what regulatory rules could achieve, and that it would be a mistake not to accept that some of the failures that had occurred had their roots in issues of culture and behaviour. He said that real reform required change in both the regulatory rules and the industry's culture. The problem was not so much about defining the ethical framework, as about identifying and encouraging the right cultures.

Europe and the world

The UK regulatory regime will have to fit with an enhanced European regime, which will remove some of the individual powers of domestic authorities, and a broader global interconnected approach. In the next chapter, we cover developments in these areas.

European and global regulation

Introduction

In this chapter, we cover some major developments in EU legislation so far, then the pending new European regulatory framework, and some of the global regulatory issues. These developments are already having major impact on the United Kingdom, which is subject to the European regime and is a major player in global developments. Read this chapter in conjunction with Chapter 22, which focuses on UK regulatory developments.

European legislation so far

The Financial Services Action Plan (FSAP) is the EU initiative to improve the single market in financial services. At its heart is the Lamfalussy process, an approach to resolving shortcomings in the regulatory and legislative system for financial services in Europe.

The FSAP imposes an EU-wide regime. Lawyers say that the EU directives imposed under the plan, of which there are more than 40, are a halfway house between principles-based and rules-based regulation.

The EU directives have mostly now been implemented, including by the UK's Financial Services Authority (FSA), with different challenges for individual countries, depending on their previous regulatory regime and their culture. The FSA has a sophisticated approach to regulation, and it has in the past criticised some EU legislation for being expensive to implement and ill thought out. There is often not much 'wriggle room' for individual country interpretation. Let us here take a look at four of the most important directives.

Market Abuse Directive

The Market Abuse Directive (MAD), implemented in the United Kingdom on 1 July 2005, allows the FSA to choose between pursuing market abuse, including insider dealing, as a civil case, requiring proof *on the balance of the probabilities*, or as a criminal case, with the much higher standard of *beyond reasonable doubt*. Previously, the only option was a criminal case. Even with this flexibility, the FSA has found it difficult to bring many successful actions for market abuse.

In April to June 2009, the European Commission consulted on whether it was necessary to review the MAD. The Commission was considering simplification of the directive and making it more effective at responding to deficiencies revealed in the financial crisis. There have been responses to the consultation, but as the third edition of this book went to press, no further public developments.

Prospectus Directive

The Prospectus Directive, implemented in July 2005, aims to give common disclosure standards across the EU member states when securities are made available to European investors through a public offer or trading on a regulated market. The Directive has introduced a single passport for issuers, which means that once a prospectus is approved in one member state, the others must accept it. An obstacle has been that many EU states still have extra requirements, and some provisions of the Directive are open to different interpretations.

In September 2009 the European Commission proposed a review of the Prospectus Directive, which would increase legal clarity and efficiency in the prospectus regime and reduce the administrative burden for issuers and intermediaries, without losing focus on the importance of enhancing the level of investment protection.

Among the proposed changes, some types of securities issue, including small companies and rights issues, will be subject to less comprehensive disclosure requirements; the format of the prospectus summary will be improved; there are clearer exemptions from the obligation to publish a prospectus when companies sell through intermediaries and for employee share schemes; disclosure requirements overlapping with the Transparency Directive (see below) will be repealed; issuers of all non-equity securities will be able to determine their home state; and the definition of qualified investors in the Prospective Directive will be aligned with the definition of professional clients in the Markets in Financial Instruments Directive (see below).

Transparency Directive

The Transparency Directive was implemented in January 2007. It provides continuing obligations for issuers whose securities are admitted to trading on an

EU-regulated market. The Directive covers the publication of financial reports, which should be prepared, or reconciled, to International Accounting Standards or equivalent.

Within the Directive are disclosure requirements for major shareholdings in all companies admitted to trading on an EU-regulated market. The requirements for content and timing are more demanding than before in most EU member states.

Unlike the Prospectus Directive, the Transparency Directive requires minimum harmonisation. It is light on guidance and is only 10 pages long. Some countries have imposed additional requirements, well above the minimum requirements, and potentially creating difficulties for foreign participants. The disclosure loopholes in the Directive enable non-disclosure of cash-settled derivatives positions, which have enabled secret stake-building without violation of disclosure rules. This factor came under scrutiny in German car parts maker Schaeffler's hostile bid for German tyre maker Continental in 2008.

Markets in Financial Instruments Directive

The United Kingdom implemented the Markets in Financial Instruments Directive (MiFID) by the deadline of 1 November 2007, although some other countries, notably Spain, were late. The directive replaced the Investment Services Directive (ISD), which had emphasised mutual recognition between member states, and is a maximum harmonisation directive, meaning that member states must not 'gold plate' EU requirements by adding to them.

The directive has established EU-wide standards in some main areas of investment business. The main changes are in pre-trade and post-trade transparency, best execution, client classification, and transaction reporting and data consolidation. There are pre-trade transparency obligations on the large banks that are systematic internalisers in liquid shares. These firms must publish buy and sell prices up to standard market size and honour them, even at retail size. Post-trade transparency requires details of all trades executed in a security admitted to a regulated market to be published.

Banks and brokers must apply a best-execution requirement from which only eligible counterparties acting as principals (that is, trading on their own book) are excluded. For retail investors, best execution is the total consideration, including expenses related to the order's execution through to trade settlement, although other factors may be given priority if they deliver the best result. For professional investors, there is a more narrow focus on the consideration; best execution must take into account speed, cost (including commissions, fees and costs such as clearing and settlement), likelihood and price. How far best execution should apply to international bonds and over-the-counter (OTC) derivatives remains controversial.

The previous client categories of private, intermediate and market counterparty are replaced under MiFID with retail, professional and eligible counterparty categorisations. There is a greater choice in trading venues, and so quotes and trades in the same security are now published through various channels.

The directive enables companies to compete outside their home market on more of a level playing field. Under the ISD, if a firm entered transactions in another member state, it needed to be registered there. Under MiFID, such cross-border transactions are regulated by the country where the firm is located, the home state. Small companies in particular now find it easier to conduct business across EU borders because the legal costs of compliance with foreign local laws will have been removed. Firms may relocate to a member state with favoured regulations, or may seek to expand by offering products abroad without having to establish branches in those EU locations.

Generally, MiFID ushered in a much greater administration burden. Firms have to maintain and update more extensive records than before for any regulated activities involving conflicts of interest, and must take a more proactive approach to finding conflicts. The FSA initially estimated an initial overall cost of implementing the MiFID in the United Kingdom of between £870 million and £1 billion, with ongoing costs of around an extra £100 million a year. The regulator said that the Directive could generate some £200 million per year in quantifiable ongoing benefits, attributable mainly to reductions in compliance and transaction costs.

According to Christopher Bond (2009), senior compliance adviser at the Chartered Institute for Securities and Investment, the credit crisis has exposed gaps in the MiFID. He noted that MiFID's control sections were set at a high level, compared with the detailed approach for conduct of business: 'We know now that they should have been treated equally and that risk management is more important than conflicts of interest.'

According to Bond, MiFID has led to dispersed liquidity and fragmented reporting, resulting in a loss of market price transparency. He noted benefits, however, including the encouragement of new trading venues, and a shift in the dividing line between retail and professional clients, moving closer to retail.

The European Commission was planning a MiFID review starting at the end of 2009, which according to Charlie McCreevy, EU Commissioner for Internal Market and Services, would take into account market developments since the directive had been implemented (McCreevy, 2009). McCreevy said in Dublin on September 2009 at the Public Affairs Ireland conference on regulatory reform in the Irish economy that the MiFID had stimulated greater competition in some areas, but there had been a significant migration of share-trading transactions from the more regulated MiFID venues to the unregulated OTC dealer venues where

substantial unregulated dark pools of liquidity had built up (see Chapter 16). He said that the MiFID review would address whether there were unfair commercial advantages for the operators of these venues, and whether the trend undermined price discovery, market integrity and efficiency for the market as a whole.

Capital Requirements Directive

The Capital Requirements Directive (CRD) was approved by the European Parliament in September 2005, and applies to all credit institutions and certain investment firms. It is the common framework for the implementation of Basel II rules on capital measurement and capital standards (see Chapter 3).

The new framework aimed to make capital requirements much more risk-sensitive, and more comprehensive, and the harmonisation of prudential rules should reduce regulatory arbitrage opportunities. The Basel Accord, including Basel II, has been revised in parallel with the EU capital requirements legislation.

In early May 2009, the European Parliament adopted revised, and tougher, bank capital rules as part of the CRD. This was the first of three revisions in the year, which were a response to the financial crisis. It introduced harmonised rules on whether hybrid capital, including both equity and debt, was eligible to be counted as part of a bank's overall capital, the amount of which determines how much the bank can lend. Under the new rules, a bank cannot lend more than 25 per cent of its own funds in most cases. Colleges of supervisors have been established for all cross-border banking groups.

Banks must now keep a 5 per cent stake in their securitised exposures, the so-called 'skin in the game', with the adequacy of this retention requirement subject to review, and firms that invest in these securities are allowed to make their decisions only after conducting comprehensive due diligence, failing which they will be subject to heavy capital penalties. There must now be controls on liquidity risks to stop banks having difficulty gaining access to day-to-day funding.

In June 2009, the European Commission proposed a second round of revisions to EU rules on capital requirements for banks. These revisions were designed to tighten up the way in which banks assess the risks connected with their trading book; impose higher capital requirements for securitisations; increase market confidence through stronger disclosure requirements for securitisation exposures; and require banks to have sound remuneration practices that do not encourage or reward excessive risk taking.

Under the new rules, banks would be restricted in their investments in highly complex resecuritisations if they could not demonstrate that they had fully understood the risks involved, while national supervisory authorities would review banks' remuneration policies and have the power to impose sanctions if the policies did not meet the new requirements.

From July to September 2009, the Commission was consulting on a third revision proposal on through-the-cycle expected loss provisioning, specific incremental capital requirements for residential mortgages denominated in a foreign currency, and the removal of national options and discretions. There was to be future consultation on a legislative proposal to restrain excessive and unsustainable balance sheet growth through a leverage ratio measure.

Europe in transition

The great fear is that EU regulation is moving towards too much of a ‘one size fits all’ approach and is politically motivated, favouring the continental European environment, and undermining the competitive advantage of London, which has the most advanced domestic financial services regulation in Europe. A first instance of such concerns has arisen with the EU Directive on Alternative Investment Fund Managers (see Chapter 19). On the upside, many in the United Kingdom are relieved that Europe is not imposing a single European supervisor and abolishing national regulators. The new regime should enhance cooperation between European supervisors.

The pending pan-European regime is based on the February 2009 de Larosière report on EU Financial Market Supervision, with which the Turner Review’s proposed reforms are much in line. In September 2009, the EC adopted proposals for the new regime, and it is now under construction.

As one part of it, there will be a college of national supervisors as the European System of Financial Supervisors, consisting of the three European supervisory authorities – a European Banking Authority, a European Insurance and Occupational Pensions Authority, and a European Securities and Markets Authority. These three authorities replace existing committees, and each one has a decision-making board of supervisors, made up of heads of national supervisory authorities. They will produce technical standards, a form of regulation on which they must consult publicly, and which will aim to make sure all EU member states implement European law. The supervisory authorities may act to require that national supervisors interpret European legislation correctly. If a national supervisor fails to take requisite measures, they can act directly against financial institutions. This is an attempt to resolve the issue of differing implementation of EU Directives such as the MiFID across EU states.

The supervisory authorities will back existing colleges of supervisors – a system that is flawed since colleges consist of national regulators who aim mainly to protect consumers in their own jurisdiction. They will provide a dispute resolution mechanism to support cross-border supervision of financial institutions. In an emergency, as determined by the European Commission, they can require

national supervisors to take joint action. The supervisory authorities have more power than their predecessor committees, which could only issue guidelines.

There will be another body, the European Systemic Risk Board, which will make broad recommendations and issue warnings. There are major concerns that central bankers are over-represented on the board partly because of their general unproven competence, given that central banks had failed to foresee or stop the financial crisis, and partly because of a conflict of interests in central banks between macro-economic supervision and the aim of price stability which accompanies setting short-term interest rates. The Board does not have full accountability; it has reporting obligations but is not subject to sanctions. It has no formal enforcement tools, which limits its ability to influence behaviour.

According to McCreevy in his Dublin speech, the European Systemic Risk Board will have to interact closely with the Financial Stability Board, recently created from the previous Financial Stability Forum (see below), on which the European Commission has a seat.

Global regulation

New global standards are planned, which aim to increase cooperation between countries, including in the United Kingdom, the United States and continental Europe. International colleges of supervisors have been established, and bodies such as Group of 20, the Financial Stability Board and the International Monetary Fund (IMF) are working towards the same end of financial stability. There is some scepticism about how well it all works, with much of the focus on the example set by the United States.

The US position

In the United States, President Barack Obama has proposed to give the US Federal Reserve, the central bank, more power to act as a systemic regulator, and has proposed that there should be a consumer finance agency. The proposals have met with opposition. In early November 2009, the US Senate proposed draft legislation that would give a new council of regulators the job of systemic risk regulation. The bill would consolidate the four banking regulators in the United States, removing some powers from the Federal Reserve, to create a single prudential supervisory body.

In terms of regulatory reform, the broad aims are the same, including addressing systemic risk and improving consumer protection. The structure of the regime for the new regulation is perhaps less important than the content. The SEC might have enhanced powers, despite earlier proposals that it should

be dismantled following its failures to act on warnings about the Bernard Madoff fraud. The SEC is tackling Ponzi scams, comparable in type if not in size to Madoff's, and has been focused on such areas as transparency around dark pool trading (see Chapter 16). The Commission has been considering whether to allow high-frequency trading, weighing the benefits of liquidity to the market against inequity to investors, and has been focused on, among other things, short selling and money market reforms.

The world watches the United States and its President Obama, but, in some areas, the US regulatory system is backward and convoluted compared with that of the United Kingdom. The culture of risk taking is also subject to retrospective focus, and ministers in some countries, including Germany and Russia, have publicly blamed the United States for the current crisis. The criticism is well deserved but the United Kingdom must also take some of the blame. The case for a connected effort is strong. In areas of financial services such as OTC derivatives or hedge funds, the United Kingdom and the United States are competing, and if regulation is too different, there will be regulatory arbitrage, an outcome that would be anathema to the aim of global integration.

Group of 20

The Group of 20 (G-20) Finance Ministers and Central Bank Governors was established in 1999 to bring together systemically important economies to discuss global economic issues. The G-20, which includes 19 countries and the European Union, plus the IMF and the World Bank, focuses on among other things financial services regulation, where the Financial Stability Board (see below) keeps it informed of progress.

The G-20 is strong on rhetoric, but so far, ideological differences between countries have proved a drag on full global consensus. There is much talk of resisting trade protectionism but the member countries are not all doing so. Other areas of contention have been on whether, or how, a financial tax on transactions should be enacted, and which countries should pay for measures to address climate change. The G-20 has very little ability to implement its decisions, and the political will in countries to follow up with coordinated action may not always be strong. Another issue is how the G-20 collaborates with countries outside the group.

International Monetary Fund

The IMF aims to ensure the stability of the international monetary system. The Fund advises its 184 member countries, makes finance available to help them to address balance of payment problems, and provides technical assistance and

training. The IMF's resources come mainly from the quotas that countries deposit when they join the Fund.

The IMF has been criticised for the strategy, sometimes called the Washington Consensus, it has imposed on countries as a condition for financing. Borrowing countries must give priority to inflation control through high interest rates, and must create open markets and liberalise banking systems. They must reduce government spending, except on repaying debt, and privatise assets. To meet IMF loan conditions, governments have cut jobs and subsidies, and made credit unavailable. In the 1990s the IMF strategy had a bad effect on Asia, and its states paid back the Fund's loans as quickly as they could.

The IMF has gained in status in the credit crisis of 2007–09 because some nations have seen no viable option but to borrow from it. By late 2008, the IMF had already agreed loans to some countries in crisis.

In April 2009 Dominique Strauss-Kahn, managing director of the IMF, said that the institution was back – as a forecaster and a policy maker, and in other types of work. He noted (2009) that IMF forecasts had become the reference for the G-20. The IMF had become a partner in discussions on policy implementation and was engaged in surveillance work, including early warnings. He noted that the IMF's resources, now up to US\$250 billion, were to be tripled to US\$750 billion, with the new implementation tool of a flexible credit line.

The G-20 later (2009a: 3, point 20; 11, point 20) confirmed the importance of the IMF's role in establishing global stability. The group later said that modernising the IMF's governance was crucial, and that it was committed to at least a 5 per cent quota share shift from over-represented to under-represented countries. This represents a shift in favour of emerging economies, and the United Kingdom would be one of the losers.

The IMF is working with G-20 finance ministers to develop cooperative and coordinated exit policies for withdrawing financial support once recovery had been fully secured. In addition, the IMF as a member of the Financial Stability Board is conducting country assessments to check compliance with FSB standards (see section below).

Financial Stability Forum

The Financial Stability Forum (FSF), established in 1999, was concerned with policy initiatives in financial stability, regulation and infrastructure. This function was designed to complement the role of the IMF, which was involved with macro-financial issues in countries.

The financial crisis that started in 2007 increased the need for countries to work together on reforms. The G-20 changed the FSF into the Financial Stability Board (FSB), with an expanded membership and a broadened mandate to ensure

financial stability, put in place in April 2009. The FSB is chaired by Mario Draghi, governor of the Bank of Italy and a former Goldman Sachs partner, and its secretariat is financed as part of the budgets of the Bank for International Settlements, the IMF and World Bank.

The FSB's primary mandate is to develop supervisory, regulatory and other financial sector policies in the interest of financial stability. The FSB coordinates international policy development in these areas, which often takes place through separate international standard-setting bodies, and fills gaps in policy not addressed through existing bodies.

The FSB is also focused on the assessment of vulnerabilities affecting the financial system, where it cooperates with the IMF in delivering early warnings analysis. The FSB acts as a clearing house for information sharing, contingency planning and other efforts at strengthening the robustness of the financial system.

In addition, the FSB has the power to conduct peer reviews to assess implementation of policies in the interest of financial stability. The G-20 has asked the FSB to provide detailed progress reports on the implementation of the FSB and the G-20's recommendations, where the FSB has set timetabled goals for its members.

The first peer review, at the beginning of 2010, was to be focused on whether domestic authorities had applied the FSB's principles for sound compensation practices. The peer reviews have no legal force but are expected to have strong influence through the disclosure of the results.

In its current work plan, the FSB is addressing the problem of how to reduce the risks from systemically important financial institution being apparently 'too big to fail'. As part of this work, the FSB will be looking at possible measures to reduce the probability and impact of failure, improve resolution capacity, including through derisking or orderly wind-down plans, and strengthen core financial infrastructure and markets.

Some have expressed concerns whether the FSB's membership might be too diverse to achieve the cooperation desired. The membership consists of G-20 countries and others, with three or four institutions from each country, including central banks, regulators and ministries of finance. The Bank of England, the FSA and HM Treasury represent the United Kingdom. The FSB had fewer countries as members – 12, including those in the Group of 7 – and yet it was not able to predict or stop the global financial crisis. Others argue that the FSB has developed a stronger approach than the old FSB to setting new policies and obtaining commitments from their members to carry them out.

The FSB promotes the development of international standards, as well as their worldwide implementation. The IMF and the World Bank, both FSB members, assess compliance with 12 key sets of financial standards, and have

conducted their Financial Sector Assessment Program in around 130 countries since 2000. The standards are written by international standard-setting bodies such as the Basel Committee on Banking Supervision or the International Organization of Security Commissions. With some exceptions in the European Union, these standards are not enforceable through international law and the assessments are voluntary.

As the third edition of this book went to press, the United States, China and Indonesia were being assessed, further widening the comprehensive coverage. The countries that have not yet taken part are not included on any formal list, but many of them are either very small countries, or suffer from political or war issues, such as North Korea, Burma, Somalia and Zimbabwe.

Some have suggested that the standards are too vague to act as firm guides, but they are designed to be applicable within different legal systems – recognising, for instance, that the French legal system is structured differently from the Anglo Saxon one – since it is not realistic to require countries to change their whole legal system.

Assessment of countries against the principles focuses on core objectives rather than the details of regulations. For instance, assessors check whether they are implementing the 30 Basel core principles, rather than check every paragraph of the capital requirements for banks. The assessors do not only ask whether the relevant law was put in place, but go to the country and talk to banks, private-sector and other individuals, asking how supervision and risk management is taking place.

FSB members have committed themselves to disclosing the results of the assessments, although publication is voluntary. FSB members recognise that there is far more to financial stability than meeting the core standards, and although leading countries worldwide were complying with the vast majority of standards, this did not prevent a global financial crisis.

As part of its broader focus on financial stability, the FSB assembled an unpublished list of financial companies that conduct cross-border business and should therefore have an international college of supervisors – where supervisors that oversee a cross-border firm would liaise with each other and cooperate in supervision. Colleges have now been set up for these groups. Officials emphasise that this is not a list of companies deemed too big to fail, and that having a college does not mean that a firm would necessarily be rescued. But the list is not published because of the risk that the public might use it as a proxy for that.

The list is understood to include a small number of systemically important insurers in addition to banking groups. The type of systemic risk posed by insurers is different from banks, but AIG's collapse illustrated that the risk can be a real one. The International Association of Insurance Supervisors and the

Basel Committee have provided full input into the work coordinated by the FSB on supervisory colleges.

Some have queried how independent the FSB is, including the G-20, which commissions some of its reports. The FSB's membership stretches wider than the G-20's.

In the financial crisis, information sharing at global level has become important, and there is an issue concerning how far the FSB has achieved this. Officials say that information sharing among authorities improved during the crisis, but work remains to be done to improve communication, at both formal and informal levels. Information sharing between FSB members takes place on several levels: through the meetings of the FSB, which take place at the level of senior officials; through more specialised committees; through surveys of its membership on existing practices and policy reforms; and through supervisory colleges and cross-border contingency planning groups.

There are concerns that in the area of systemic risk, the sheer number of bodies being established could create more muddle than clarity. Bodies focused on macro prudential and other financial stability analysis include the IMF, with which the FSB cooperates, and the European Systemic Risk Board. The UK government is planning to set up a new Council for Financial Stability. In the United States, the Administration and Congress have proposed a new council of regulators to focus on systemic risk. The FSB has been created in part, however, to reduce the risk of 'muddle' through its coordination role. The FSB will focus on coordination at the international level, while regional and national coordination will fall to other bodies.

Financial fraud

Introduction

The City attracts fraudsters because of its substantial movements of money through various asset classes and its global connections. In this chapter we shall look at the scale of fraud, the City resources available for dealing with it, and the success achieved. We examine the roles of regulators, police, the government and various organisations, as well as legislative developments. Read this together with Chapter 25, which covers money laundering.

Overview

Fraud losses in financial services were estimated at just over £1 billion in 2005, according to a report published in early 2007 (Levi *et al*, 2007). Such estimates give a very broad idea of the scale of the problem; nobody knows the true figure. Financial fraud increasingly crosses asset classes and jurisdictions, and highly sophisticated scams are organised by gangs of professional criminals who can shift easily from one fraud to another. The proceeds are often laundered into the banking system (see Chapter 25) and used to fund further fraud.

The credit crisis has not just made some City workers succumb to the temptation of fraud, but has brought to light frauds carried out in the past, of which mortgage fraud has been a prominent example.

One of the major concerns is whether there is the government will to stop fraud. Some City lawyers specialising in City fraud have said they feel there is not. There is also a lack of understanding. White-collar fraud is sophisticated, and as the Serious Fraud Office has so often complained, juries find it difficult to understand. To investigate fraud can take enormous resources, over extended periods, and often results in either no prosecution or an acquittal.

Government initiatives

At least the legal concept of fraud is now clearer and broader as a result of the Fraud Act 2006, which came into force in January 2007, replacing a complicated array of over-specific and overlapping deception offences. This established a new general offence of fraud by false representation (which includes ‘phishing’, discussed later in the chapter), by failing to disclose information and by abuse of position.

There was more change to come. The *Fraud Review* commissioned by the government (Attorney General, 2006) was followed by a public consultation. In March 2007, the government launched its response, *Fighting Fraud Together* (Attorney General, 2007), and, in October that year, it announced over £28 million of new funding had been committed to making the UK the world’s hardest target for fraudsters. The anti-fraud funding was not confined to financial services, but would pave the way for initiatives that would benefit the City, including a new lead force, centred on the City of London police, a new National Strategic Fraud Authority, a National Fraud Reporting Centre, pilots to measure the impact and cost of fraud, and reforms to the criminal justice system. Mike Bowron, City of London Police Commissioner, said that with this funding the City of London police would be able to make serious inroads into reducing the estimated £20 billion a year that fraud was costing the country.

In 2008 the National Fraud Strategic Authority was established, as planned, to lead and coordinate fraud prevention activities. It seeks to understand the scale and shape of fraud, and to have a strategy for it. The National Fraud Reporting Centre, part of the same government initiative, will gather intelligence and measure fraud, acting as a centre for reporting all kinds of fraud. The idea is to provide a one-stop-shop for fraud victims and to prevent duplication in fraud reporting, providing a more sophisticated sharing of data between different areas of financial services, government and non-government agencies. Simon Arundel, risk manager, claims and risk services at Ecclesiastical Insurance, said at the IEA and Marketforce Claims Forum in June 2009 that many claims would not be reported to the centre, and even when they were, they would sometimes not be investigated (Davidson, 2009c). He said that, even with this limitation, putting reported fraud claims in one place would, however, give a better picture of where fraud was happening, and its scope and size.

As part of the *Fraud Review*, the government proposed a review of how courts should address issues arising from fraud, and there was discussion about implementing a financial courts jurisdiction with specialist judges so that all aspects of fraud proceedings could be dealt with in one place. Another idea was to explore a way of encouraging early guilty pleas through a safe legal framework, which would protect defendants’ rights and also improve the experience of

victims. The use of plea bargaining to put pressure on criminals to give information about their colleagues has worked well in the United States.

Meanwhile, the UK government is developing a comprehensive strategy for tackling foreign bribery. This involves a draft bribery bill, designed to reform the criminal law to create a new category of bribery offences.

Extradition issues

A 2003 extradition treaty between the United Kingdom and the United States, ratified by both countries in April 2007, modernises and extends the extradition arrangements, aiming to make it easier to bring offenders from either state to justice.

The extradition arrangements came under criticism when three former employees of NatWest Bank were extradited to Texas in 2006 to stand trial on seven federal counts of wire fraud in relation to the Enron case. The United Kingdom originally ratified the treaty to show solidarity with the United States in the fight against terrorism. Critics said the *NatWest three* extradition showed that US prosecutors were using the treaty to pursue alleged white-collar fraud cases, and that the British government should never have ratified it. They were fed their case by a clever PR campaign. Robert Wardle, the former head of the Serious Fraud Office, has claimed that there would have been enough evidence to extradite the three under the old extradition arrangements.

In the United Kingdom, attitudes towards bankers and insurers have conspired to make certain types of fraud more acceptable, including exaggerated insurance claims, according to financial crime stakeholder research published in March 2007 by the Financial Services Authority (FSA), the City regulator.

Specialist areas of fraud

Boiler rooms

One City-related problem that the combined efforts of the FSA and the City of London Police have not been able to crack is the fraud committed by boiler rooms selling worthless shares. This was once only a telephone sales scam, but now the fraudsters use the internet as well. Until the early 1990s these firms operated freely in the City. With a tightening-up of financial services regulation over the past couple of decades, they are now more likely to target UK investors from jurisdictions such as Spain, Gibraltar, Hong Kong and Croatia.

The salespeople take the initiative in calling targeted investors, offering them a 'hot investment opportunity'. They generally use false names, and if the

investor rings them on the UK number given, the call is likely to be diverted abroad. Such tactics make it hard to trace the fraudsters. They choose a physical base where local police there are not concerned about fraud that does not target nationals. If the police do investigate, the telesales team simply moves to another jurisdiction.

In the early stages of selling, the boiler room might refer potential investors to a fake company website, or represent its share-selling campaign as an initial public offering (IPO) or a private placement, and send out a prospectus with unrealistic profit and cash flow projections. The company – which might not even exist, and if it does, is probably not generating revenue – is often represented as high-tech. The salespeople are often paid a commission of between 10 and 60 per cent, many times the usual rate for advisory stockbroking. Once someone has opened a client account, the lead is passed onto a ‘loader’, who proceeds to load the individual with as much stock in as short a time as possible.

A variation is a pump-and-dump, a planned sales campaign that sends the share price artificially spiralling. The promoters will have bought shares earlier through a nominee account, and make a huge profit from selling out high, at which point the share price collapses, leaving most investors holding overpriced stock that they cannot easily sell.

In more subtle variations, the broker promises clients, ‘You will be in and out within a month,’ and predicts a small profit – big enough to entice experienced investors, but not enough to make them suspicious. Sometimes the boiler room simply pockets the proceeds of any cheque sent in, perhaps ostensibly for shares in respectable blue-chip companies, then disappears, but on other occasions it strings clients along, and it is some time before they realise they have been scammed. Any request to sell out is fobbed off: the broker will say clients should stay invested because of market conditions or the exchange rate. If the firm allows investors to sell, it will be only if they reinvest in an equally dubious stock. Whichever way, the clients will never see their money again.

Every boiler room has a limited life because of complaints and mounting pressure from the authorities. On its collapse, however, the boiler room often re-emerges under another name, and a related outfit might even approach the victims and offer to recover the money they lost for an upfront fee.

An unscrupulous firm occasionally takes over a struggling company whose good name it exploits. The new owner will stave off suspicious regulators and others, often hiding behind lawyers, as the firm rips off clients. The merged company, like other boiler rooms, can operate only for a limited time.

The victims are often older and experienced investors, and they tend not to learn from their mistakes. In June 2006 the FSA published a survey of 100 investors hit by boiler room fraud (FSA, 2006b), and found that 64 per cent

were over 50 years old, 41 per cent had been investing for more than 11 years, and 13 per cent had been conned by more than one boiler room. Of those surveyed, 20 victims, the largest number, were from London and the South East, where the average investment was £21,823. Legislation in the form of the Companies Act 2006 has made it harder for boiler rooms to gain access to share registers, but as the FSA has pointed out, this does not protect investors whose names are already in circulation among the fraudsters.

The FSA cannot do much about boiler room frauds if they are conducted from abroad, unless UK-based individuals are linked to the scam, in which case it has shown readiness to move against them. In early 2009 it won an appeal against Fox Hayes, a Leeds-based firm of solicitors that used its FSA-authorized status to approve promotional material used by overseas boiler rooms to defraud consumers. In another case the FSA wrote to every shareholder on a sucker list, and in some instances there is consumer redress.

Beyond this, the FSA makes threatening noises and keeps a lengthy, if outdated, list of boiler rooms on its website. Another not very effective initiative is Operation Archway, a database on fraudulent share-dealing operations established by the City of London Police. One problem facing the authorities is a lack of resources, but the FSA has recently had an increase in funding, and at its Annual Crime Conference in April 2009, Margaret Cole, its director of enforcement, said it intended to do more to deter share fraudsters. Another problem is that cooperation between regulators and law enforcement agencies in different countries can still leave a lot to be desired.

To find out in more detail how boiler rooms operate, watch the 2000 US film *Boiler Room*, starring Ben Affleck. It is very true to life. Details are in Appendix 2.

Advanced fee frauds

Some boiler rooms work not through investments but using advanced fee frauds. There are variations on the theme, but the outcome is always the same: the promoters take a fee or down-payment, but do not deliver whatever was promised.

The 419 fraud is the best-known type; it is named after the section of Nigeria's penal code that addresses fraud schemes, although this scam is not exclusively from Nigeria. People are sent an e-mail, sometimes purporting to be from a government or bank official, which contains an ungrammatically worded plea for help. The impression is given of an uneducated but sincere correspondent. The most common request is to make temporary use of the target's bank account for depositing large government or other funds in exchange for a commission of up to 30 per cent. Anybody who responds is asked to pay an upfront fee. If they pay up, further fees are demanded. There is no underlying

transaction, of course: the point of the scam is to harvest the fees. Variations include an invitation to travel to Nigeria or a neutral country to complete the transaction: anyone who makes the trip is fleeced by the crooks. Accomplices claiming to be local police may demand a further fee to retrieve any transmitted funds. Parties who resist paying money at either of these stages may be threatened by the fraudsters, and cases of kidnap and murder have been documented.

In another variation, a supposed bank — represented through a website, and with an address that is not easy to check, perhaps in Guernsey, Jersey or the Isle of Man, or in a street that does not exist — offers loans for a fee. Sometimes a name similar to that of a big recognised financial institution is used to instil confidence. If someone responds and pays the loan arrangement fee, the operation evaporates (only to start up elsewhere in a similar fashion) and the loan itself is never paid over. It is hard to prove who the perpetrators are since no identification checks are required for someone obtaining a web address and starting up a site.

Other variations are the lottery scam — a letter or e-mail announces a lottery win, but the person must pay a large fee in return for being given the details needed to claim it — and the legacy scam, where the message announces that the recipient might prove to be the beneficiary of someone's will, but they must again pay up in order to get further information.

The City has had some limited success in catching advanced fee fraudsters, and there has arisen an enjoyable culture of baiting them by pretending to be ready to go through with a transaction. These scams have claimed all too many victims in the United Kingdom as well as the United States and elsewhere, and the victims are sometimes reluctant to complain for fear of appearing to have willingly complied with a blatantly dubious money-making scheme.

Identity theft

Identity theft or concealment is a theme that runs through a lot of fraud and money laundering activity. Individuals often use an invented name, or a real name that is not their own, to open accounts with the idea of perpetrating fraud. It used to be easy to open a bank account without verification of identity, but the requirements have now been tightened up considerably. Still, many of these crooks rely on firms not doing due diligence. They are adept at falsifying identification such as bank statements and gas bills. Passports can be faked, or real ones bought from corrupt officials, especially in third-world countries. In one case, the equipment used to make false passports was more modern than the Home Office's.

There are known geographical black spots, including some within London. Sometimes a small band of crooks are responsible for a large number of applications in false names. Or the perpetrator might be a fake company: typically

one set up offshore in a jurisdiction with no reporting requirements, with its real ownership hidden behind anonymous bearer shares.

The United Kingdom attracts the largest amount of credit card fraud in Europe, and a major feature of this is identity fraud. One of the techniques is phishing, where crooks send out bulk e-mails that pretend to come from a legitimate financial institution, asking recipients to confirm their credit card or bank details. Another proven method is to telephone the mark, pretending to be from a credit card company, and ask for card details in order to ‘check on suspicious activity’ on the card. Criminals can also read and record details and PIN numbers remotely from cards used in automated teller machines (ATM), by attaching a card reader to the front of the card slot and a pinhole camera above the keypad.

Grab-it-and-run is a crude method of identity fraud. Recently, gangs of young Romanians, both male and female, have been posing as distributors of free newspapers near cashpoints in the West End, particularly around Oxford Circus, Mayfair and Goodge Street, and in the City of London. They wait until their victim, typically a woman, has keyed in her pin number and hit the ‘get cash’ option before they approach her on both sides, jostling her and thrusting newspapers in her face. Under cover of the newspapers, one of the team on the left hits the £200 button and another on the right grabs the cash. They work so fast that those in the queue to the ATM assume they were simply harassing her to take a paper.

An ATM fraudster can make between £3–4 million a month, which is why some perpetrators will go so far as to kill people to gain turf, according to one money-laundering reporting officer.

An analysis of fraud trends during 2008 by CIFAS, the UK’s fraud prevention service, has shown a year-on-year 207 per cent increase in facility takeover frauds, where a third party gains access to, and fraudulently uses, an account belonging to an innocent victim. Phishing, telephone scams and the interception of credit cards and statements enable such scams.

Insurance and reinsurance fraud

Insurance fraud can be broadly split into two categories: claims fraud against insurance or reinsurance companies (see also Chapters 28–31), and fraud within the company itself. Informal feedback from regulators suggests that fraudulent claims amount to 5–10 per cent of premiums, of which only 10 per cent is discovered and averted, but much of this is guesswork. The latest regulatory thinking is that throwing further resources at claims fraud prevention does not work, but that consumer education is needed to end the widespread misapprehension that to cheat an insurance company is a victimless crime.

Reinsurance companies can receive dubious claims from insurers, and their own underwriters or claims people have been known to put pressure on the company not to investigate favoured clients. In some reinsurers, the board pays lip service to fighting fraud, but the work gets dumped on overworked claims departments. Many firms cut back on hiring investigators to save costs.

Eastern Europe has proved a hotbed of large and dubious reinsurance claims. Munich Re has had substantial and sometimes unjustified reinsurance claims from warehouse fires in Eastern Europe. The reinsurer has found that it can be problematic to deal in such countries as Russia, and local representation is important. Courts in Russia base their decisions on contractual documentation, and it is sometimes felt that to win a case, the litigant needs to know the right people.

Respectable insurers sometimes find that fraudsters hijack their name. Lloyd's is a prominent victim, although individual syndicates are named only rarely in the bogus documentation. The frauds against Lloyd's have tended to be in the United States, which demonstrates the international nature of insurance fraud. Lloyd's has been involved in many prosecutions, not all of which reach court.

Less obviously perhaps, fraud can occur within insurance and reinsurance companies. This may involve theft of premiums or company assets, or fee churning, where intermediaries take commissions through reinsurance agreements and the initial premium is reduced to nothing by repeated commission payments. Some fraudulent operations are based in London or the United States; others use obscure or even non-existent jurisdictions, and perhaps a London contact address.

The fundamental nature of insurance company fraud has not much changed. Andy Wragg, senior manager for international regulatory risk at Lloyd's International Market Access, has pointed out (Wragg, 2007) that some recent insurance insolvencies have shown the characteristics highlighted in 'Failed promises: insurance company insolvencies', a report published in February 1990 by Congressman John Dingell's subcommittee in the United States. Problems flagged by Dingell included inadequate reserves, misleading financial statements and general falsehoods. But Wragg has noted that there are now fewer insolvencies, and coordination between regulators has improved.

Fraud busters

The Financial Services Authority

The FSA has a statutory objective of reducing financial crime, although unlike in its other three objectives, the regulator is one of several bodies with responsibilities in this area. The objective is substantially linked with prevention of money laundering.

According to a National Audit Office review of the FSA under Section 12 of the Financial Services and Markets Act, requested by HM Treasury in June 2006, the FSA devotes less than 10 per cent of its resources to its financial crime objective.

The FSA takes an interest in fraud or corruption particularly if it is linked to systems and control failures. For example, in December 2007 it announced that it had fined Norwich Union's life and pensions business £1.26 million for putting customers at risk of fraud by failing to protect confidential information. In January 2009 the regulator fined Aon Ltd £5.25 million, its largest financial crime-related fine to date, for failing to take reasonable care to establish and maintain effective systems and controls to counter the risks of bribery and corruption. Aon had made suspicious payments amounting to US\$7 million to overseas firms and individuals.

The City of London Police

The City of London Police have 158 officers dedicated to preventing and investigating fraud, and are well resourced for this purpose in comparison with other police forces. Subsequent to the Fraud Review, in October 2007 the City of London Police became the acknowledged lead force within the United Kingdom for economic crime investigation.

The Insurance Fraud Bureau

The Insurance Fraud Bureau (IFB) was launched in July 2006, eight months from conception, after the Association of British Insurers approved the use of current industry-shared data to tackle fraud. The IFB running costs – £8.6 million over five years – are levied from its members. Bogus and inflated insurance claims cost the insurance industry over £1.5 billion a year and add 5 per cent to the premiums of honest policyholders, according to the IFB. The Bureau focuses less on small opportunistic insurance frauds, such as a false claim for a burn on a carpet, which can be handled by individual companies, and more on sophisticated cross-industry frauds such as staged motor accidents.

The IFB works closely with business partners in using analytics to focus on and identify networks of fraudsters. It can then take pre-emptive action at an early stage, and where there is the option, it prefers to prosecute. The Bureau has a strong public presence and is frequently quoted in the UK press.

In mid-2009, Richard Davies, deputy chairman of the IFB and fraud risk manager at AXA, identified in a conference speech some main areas of concern (Davidson, 2009c). Among these were still poor quality data, and the need to establish closer links to the Association of British Insurers and other bodies involved in fighting financial fraud.

The Insurance Fraud Investigators Group

The Insurance Fraud Investigators Group (IFIG) is a UK-based not-for-profit organisation focused on detecting and preventing insurance fraud, mainly in UK claims. The organisation has strong links with law enforcement agencies, regulatory and trade bodies, and other anti-fraud organisations.

Peter Upton, IFIG chair, said in a September 2009 interview with Complanet (Davidson, 2009a) that by sharing intelligence, IFIG members had detected frauds that they would not have identified individually. For example, a person might claim for a lost Rolex watch with one insurer, then later make a claim for the same watch with another insurer. This type of data sharing is compliant with the Data Protection Act 1998, and often leads to detecting fraud, although not always to prosecution. Since October 2008, IFIG members have been able to share intelligence with government and other public bodies.

The International Association of Insurance Fraud Agencies

The International Association of Insurance Fraud Agencies (IAIFA) was formed in 1986 and is also focused on insurance fraud. The association coordinates the efforts of law enforcement agencies, government bodies and the insurance industry in the fight against fraud. Lloyd's (see Chapter 29) is a member of the IAIFA and was a sponsor of its 2007 annual meeting.

The association aims to give the insurance industry a larger role in the organisation, to obtain further financial support through membership fees, and to establish links with organisations such as the International Association of Insurance Supervisors. A database and training programmes are in the process of being created.

The Serious Organised Crime Agency

The Serious Organised Crime Agency (SOCA) came into being at the start of April 2006. It replaced the National Criminal Intelligence Service (NCIS), and took control of the organised crime investigations previously conducted by Customs and Excise and the immigration service.

The agency, which has around 4,000 staff, aims to prevent, detect and reduce serious organised crime, and to gather, analyse and disseminate information on crime. In its annual plan 2008/09, the SOCA said that organised crime was complex, with sectors tied together by themes such as money laundering, and by the fact that those committing crimes would change their activity according to their perception of opportunities and risks.

In June 2009 Sir Stephen Lander, chairman of the SOCA, told Britain's Home Affairs Committee that the SOCA had underestimated the scale of serious crime and some of the organisational difficulties of getting started, but he rated its performance at 8 out of 10 for the previous year. At the hearing David Winnick, a Labour MP, accused the agency of failing to get value for money after it emerged that over three years it had recovered £78 million from criminals at a cost to the taxpayer of £1.2 billion. Lander said that seizing assets was not everything, and that it had also stopped gangs gaining an additional £460 million.

Serious Fraud Office

The Serious Fraud Office (SFO) is an independent government department with 310 permanent staff, and is part of the UK criminal justice system. It started operating in April 1988 and has jurisdiction only over England, Wales and Northern Ireland.

The department investigates and prosecutes serious or complex fraud cases exceeding around £1 million in value. It selects cases on such criteria as whether they have a significant international dimension, give rise to widespread public concern, or are complex and require specialist input.

The SFO's cases tend to have a gestation period of four to five years, and the cumulative conviction rate stands at about 70 per cent. About 65 per cent of the cases have an international dimension, and the SFO liaises with authorities in many jurisdictions. The SFO has had some high-profile successes, including the BCCI investigation, which led to six convictions, the latest in April 1997, and the Barlow Clowes case, where the principal defendant, Peter Clowes, was sentenced to 10 years in February 1992. In the Guinness case, following an SFO investigation, the four principal defendants were convicted in September 1990.

The SFO's failures have been no less publicised. One was the Blue Arrow trial, which cost taxpayers an estimated £40 million. Another was the 1996 indictment of Ian and Kevin Maxwell, sons of Robert Maxwell. They were found not guilty of fraud charges after a trial that had lasted eight months and cost taxpayers £25 million. This is one of the cases that led to government proposals to scrap jury trials in complex fraud cases on the basis that juries do not understand the evidence. The House of Lords has so far rejected the proposals.

There have been controversies. The SFO was involved in investigating corruption allegations at arms manufacturer BAE Systems as part of the Al Yamamah arms deal. In December 2006 the inquiry stopped because of a claimed need to safeguard national and international security. In July 2008, in a unanimous 5–0 ruling, the Law Lords overturned a decision by the High Court that the SFO had acted unlawfully. The Organisation for Economic Co-operation and Development's Working Group on Bribery has reviewed the UK's anti-bribery

measures following the SFO's decision to drop the investigation, and criticised the UK's poor record against bringing action against companies.

In recent years the SFO has become better resourced, although critics say that it still does not attract the best investigative staff because it cannot afford to pay private-sector rates. The SFO has a budget of around £40 million a year, funded by the Treasury, to cover its normal run of operations, and has the ability to make applications for more.

Richard Alderman, the current director, has helped to give the SFO a new, more dynamic and more US-influenced image. In a speech on 30 April 2009, 'The changing face of fraud trials', Alderman, a year into office, said that 'proactive' was now a key concept for the SFO. He wanted the SFO to go out and find cases and to be an intelligence-led organisation. The SFO had to act fast, as it did in January 2009 over some UK matters related to US fraudster Bernard Madoff.

According to Alderman, the SFO now has three domains: (1) city, corporate and public sector; (2) corruption; and (3) individual and investment. The SFO is interested in discussion about guilty pleas in fraud trials being made earlier and more transparently, as in a framework set out by the Attorney General.

The SFO has a new power, the Serious Crime Prevention Order, already in use, by which it can ask the High Court to impose restrictions on the way someone carries out business. Another new power is the ability to obtain an order for civil recovery of property obtained through unlawful conduct. The SFO works closely with police forces, including the City of London police.

The future

In a speech on tackling financial crime in the economic climate of the time at the FSA's Annual Crime Conference in April 2009, Sally Dewar (Dewar, 2009), who heads up the FSA's wholesale division, quoted from Hegel, the German philosopher, 'If history teaches us one thing, it's that history teaches us nothing.' She said that this summed up the cyclical nature of the scandals that continued to rock the financial system to its very core, from Barings, Worldcom and Enron to SocGen, Satyam and Madoff. 'We must learn from the past. In order to do so, people must start to move away from the mindset of just doing enough to satisfy the regulators and start thinking about the real risks of financial crime to their businesses.'

Regulators and law enforcement have some way to go, and in the area of plea-bargaining, among others, the United States is proving a role model. The US law enforcement process is better resourced, with access to more advanced crime-detection techniques, and the prison sentences are far harsher.

Money laundering

Introduction

In this chapter, we shall see how money laundering works, some regulatory measures to combat it, and some problems arising. We shall also consider the scale of the problem. Read this chapter in conjunction with Chapter 24.

Overview

Money laundering is the washing of dirty money through the financial system to make it clean. Cocaine production in South America, oil production in Africa and terrorism in the Middle East are all fertile sources of dirty money that ends up getting washed. Money laundering is multi-jurisdictional, taking place in London and other big financial centres, but also offshore and via the internet. Differences in regulation and legislation among jurisdictions remain, and there is not enough mutual cooperation, which makes the money launderer's job easier. It can be hard to pinpoint the geographical jurisdiction of some transactions. There is often a political focus on being seen to take anti-money-laundering (AML) action, and the action taken can be the wrong type.

The textbook approach to money laundering is to break it down into three stages. The first is placement, in which the launderer introduces dirty money, the proceeds of crime, into the legitimate financial system; the second phase is layering, by which they attempt to separate the proceeds in time and space from the original acquisitive crime by moving them through a series of financial transactions; the third stage is integration, at the end of which the launderer has created a legitimate explanation for the source of these funds, allowing them to be used openly as an individual would use honestly acquired assets.

Know your customer

Financial services regulation and legislation, including in London, focuses on account-opening procedures, and it is hoped to detect money laundering placement at this stage. Banks and other financial firms must verify the customer's identity, using 'know your customer' (KYC) procedures, and should recognise and report suspicious transactions. The procedures are far from fool-proof, and there is a case to be made that, in the long run, the shift towards electronic banking and electronic money will debilitate them further.

The KYC process is particularly important when it comes to politically exposed persons (PEPs), who are those (together with family and close associates) who are entrusted with prominent public functions by a non-UK state. There is a minority group of corrupt PEPs, who often operate through complex structures involving anonymous trusts and shell companies.

Individuals within financial services firms, or the firms themselves, sometimes help money launderers. It helps that there are corrupt officials, politicians, lawyers and other advisers across continents, and whole jurisdictions that will turn a blind eye.

As a further protective measure, launderers can easily conceal their identities. As we saw in Chapter 24, false passports can readily be obtained by criminals. Money laundering reporting officers (MLROs) are appointed by financial services firms and have many duties, but they are not trained to detect the fakes.

If the conventional banking system seems too risky, launderers may use the *hawala* system, which works by allowing cheap and unrecorded money transfers. Through this system, which is widely used today, a person pays dollars in the United States to a broker, who informs a partner in another country, who makes an equivalent payment in the local currency. No physical transfer of funds will have taken place, and the broker and their partner settle the amounts owed through fake invoices using, for example, the firm's ostensible import-export business.

Action against money launderers

Global

The Financial Action Task Force on Money Laundering (FATF) was established by the G-7 Summit held in Paris in 1989. It was given the task of examining money laundering, reviewing action taken and setting out what needed to be done. The FATF started with 16 members and now has 32.

In April 1990 the FATF published 40 recommendations on money laundering. It has since increased them to 40+9 recommendations, the extra ones aimed at combating the financing of terrorism. There has been a lack of uniformity in implementation of the recommendations, which have now been incorporated into EU legislation (see below under ‘The European Union’).

Since the 11 September 2001 attacks on the United States, constraints on cooperation between law enforcement offices globally have been lifted and information flows have improved, although a perceived mistrust between investigators across countries remains.

The Egmont Group is an unlimited network of financial intelligence units, established at a 1995 meeting in Brussels. It has 105 member jurisdictions after Bolivia was struck off. The group has its own secure website and enables cross-pollination of intelligence on financial investigations around the world.

The United States

Under the Bank Secrecy Act (BSA) of 1970, which was the first legislation to combat money laundering in the United States, banks must report client cash transactions of US\$10,000 or more. ‘Smurfers’ have been known to make small payments to accounts in many banks simultaneously in an attempt to avoid triggering these reports. The Money Laundering Control Act of 1986 amended the BSA to make it more effective, and defined money laundering as a federal crime. It made structuring transactions to avoid BSA reporting a criminal offence.

Shortly after 9/11, the US government launched the PATRIOT Act, an acronym for Providing Appropriate Tools Required to Intercept and Obstruct Terrorism, to combat international terrorism. The Act requires financial institutions to make specified KYC checks, and significantly expanded the powers of US law enforcement for the announced purpose of fighting terrorism. It introduced ‘reverse’ money laundering, which refers to the criminal purposes to which money is put to use after it leaves the bank.

The PATRIOT Act aimed to control foreign banks dealing with US institutions and has led to substantial AML activity, some of which, industry feedback suggests, has seemed to be for form’s sake. Non-US financial institutions that fail to comply with the Act may be denied access to all financial markets dealing in US dollars.

The European Union

The first EU Money Laundering Directive was introduced in 1991, in response to the FATF’s 40 recommendations on money laundering (see under ‘Global’

above), and became legislation in all member states. Its only predicate offence was money laundering from the proceeds of drug trafficking.

The second EU Money Laundering Directive, in 2001, widened the predicate offences to include organised crime, corruption and other serious crimes, and brought new gatekeepers such as accountants into the regulated sector.

The third EU Money Laundering Directive was implemented in the United Kingdom in December 2007, with the support of the Financial Services Authority (FSA) and the Treasury. The Directive uses the current FATF standards, and is intended to be embodied in industrialised countries' legislation. There are some new definitions, including one for PEPs, and more detail, including a distinction between enhanced and simplified due diligence.

The Directive has an explicit risk-based approach written into it, which means that firms must apply a proportionate approach, focusing more on areas of greater risk. The UK Treasury has acknowledged industry complaints that some jurisdictions might take advantage of this flexibility, but takes the view that good regulation rather than more EU legislation is the answer.

The United Kingdom

The United Kingdom has implemented the third EU Money Laundering Directive through the Proceeds of Crime Act 2002 (POCA) (see below) and the 2007 Money Laundering Regulations. The FSA, the UK regulator, has issued high-level rules and guidance on financial crime and AML. Much of the detail on AML obligations is in the Joint Money Laundering Steering Group Guidance, to which FSA rules refer.

Suspicious activity reports

Suspicious activity reports (SARs) are a disclosure of money laundering, and are made to the Serious Organised Crime Agency (SOCA) (see Chapter 24), of which the once stand-alone Asset Recovery Agency (ARA) is now part. SOCA adds value to SARs by investigating, and farming out the reports to investigation agencies such as the police. SARs can also be made under the Terrorism Act 2000.

The City of London police claims, unlike other police forces, to check all the SARs that are passed on to it. Sometimes the police have some luck, connecting names on separate SARs and matching fingerprints of suspects with those held on a police computer as a result of, for example, drink-drive convictions. The Egmont Group, discussed earlier in this chapter, provides intelligence that can help to clinch an investigation's success.

The Proceeds of Crime Act 2002

The Proceeds of Crime Act 2002 (POCA) provided new financial investigation tools, and is very broad ranging. Juries easily understand the money laundering offences in the POCA, and many of the anomalies and complications in earlier offences are swept aside.

Under the POCA, an employee of a financial institution may go to jail for having failed to follow the correct AML procedures, which includes filing SARs to the SOCA. Firms must wait seven days to receive consent to continue with suspicious transactions, and in the meantime must stall, but not tip off the client. If consent is refused, a firm will be constrained from continuing the transaction for 31 days, which gives the police time to investigate.

If a financial services firm is required not to release client funds, this can put it in an awkward position if the account holder wants access to them. It may be in breach of POCA if it pays the customer, or if it withholds the funds, and tips off the client that it might be under suspicion by not providing a sensible explanation.

In 2005 Stephen Judge was faced with a dilemma of this kind while working at a spread-betting firm, and he subsequently became the first British MLRO to be prosecuted for authorising a payment without receiving consent. The Crown Prosecution Service later dropped the case, giving as the main reason that it could not establish that the funds repaid to the client were criminal property.

The Serious Crime Act 2007

The Serious Crime Act 2007 allows civil recovery of unlawful conduct in the absence of a criminal conviction. These civil recoveries were previously available only to the ARA.

Systems and controls

So far, the FSA has not announced the discovery of any money laundering, but it penalises firms that it has discovered to have inadequate systems and controls. In December 2002 it fined the Royal Bank of Scotland (RBS) £750,000, the first penalty against a financial institution for failure of money laundering controls since the FSA assumed regulatory control in this sphere in December 2001. The fine was comparatively low because the bank's management addressed the shortcoming promptly and took an open and constructive approach to the regulatory investigation, according to the FSA.

The cases continued, and in February 2007 Nationwide Building Society was fined £980,000 for systems and controls failings in a case based around the theft

of a company laptop. In May of the same year, BNP Paribas was fined £350,000 for systems and controls failures that enabled an employee to steal £1.4 million.

In April 2008, the FSA urged firms to change their attitude to data security and to do more to help prevent their customers falling victim to identity fraud and other types of financial crime. This followed an FSA review of systems and controls at 39 firms across the financial service industry, which found some good practices, but that many firms were underestimating the risk of data loss and fraud to their businesses, and especially to their customers.

As a follow-on, the FSA reviewed financial crime risks in functions that UK firms had moved offshore. In April 2009, it reported that it had found good data security controls, but continued effort was needed to ensure that they did not break down and that they remained valid and risk based, and that high staff turnover presented a high financial crime risk. The FSA said that local staff with financial crime responsibilities had to be given proper financial crime training over and above their intimate knowledge of technical processes.

In October 2008, the FSA fined Sindicatum Holdings, a corporate advisory firm, £49,000 for failures around its AML systems and controls, and for not adequately verifying and recording its clients' identities. The regulator also fined Michael Wheelhouse, the firm's MLRO, £17,500 in relation to his failures in overseeing and implementing the AML systems and controls. Both fines included a 30 per cent discount for settling with the FSA, and reflected the firm's limited financial resources. It was the first time that the FSA had ever fined an MLRO for weak AML controls, and was a warning to firms.

The size of the problem

The Treasury has estimated that £25 billion of criminal money passes every year through the economy. If this figure is right, which nobody can verify, it is uncertain whether it represents fresh money, or simply £5 billion circulating through the system five times.

On one MLRO's estimates, at best less than 1 per cent of money launderers in the United Kingdom are caught, and it is hard to achieve even this.

The 2007 FATF review of the United Kingdom found it was compliant, or largely so, with 36 of the 40+9 recommendations, which compared well with other countries. The United Kingdom was non-compliant with the recommendation on PEPs, and this to some extent remains a weakness. PEPs may control a trust without being named in a trust deed.

Transparency International, the world's leading non-governmental anti-corruption organisation, said in a June 2009 report, *Combating Money Laundering*

and Recovering Looted Gains (2009: 8) that the United Kingdom has an added responsibility arising from its unique status. 'London's international reputation has often attracted money launderers who find it easy to mingle their dirty funds in a larger centre with substantial flows of legitimate money.'

Global cooperation

Law enforcement bodies are agreed that the only way to address the problem is through global cooperation. As a member of G-7 and G-8, the United Kingdom has participated in discussions about exchanging information to fight money laundering, but there has been slow progress in turning talk into action.

There is some concern that offshore financial centres are used to conceal laundered money as well as for tax evasion. Under pressure from the Organisation for Economic Co-operation and Development, and from the European Union and the United States, some jurisdictions with offshore financial centres have issued bilateral tax information exchange agreements, and the United Kingdom is currently reviewing this area.

Overview of corporate governance

Introduction

This chapter explains how corporate governance works. We shall look at, among other aspects, the Cadbury Code, the Combined Code and the Myners Report, and the Listing Rules. Read this together with Chapter 27, which focuses on governance in relation to accounting.

The concept

Corporate governance is about how a company conducts its corporate affairs and responds to stakeholders, employees and society. It covers ethical, legislative and other rules specifying how a company should act.

The issues are not new. In 1776, economist Adam Smith said in his book *An Inquiry into the Nature and Causes of the Wealth of Nations* (Smith, 2002) that managers could not be expected to manage other people's money with 'the same anxious vigilance with which the partners in a private copartnery frequently watch over their own', and that 'negligence and profusion, therefore, must always prevail'.

The corporate governance framework in the United Kingdom and elsewhere has, at least since the early 1990s, been a mixture of regulation and best practice. There has been more regulation introduced into the UK corporate governance framework recently. Much of it has been through the European Union, including the Business Review (see Chapter 27) and mandatory audit committees, but some has arrived in the new Companies Act, including codification of directors' duties.

Most independent studies on different corporate governance regimes place the United Kingdom at or near the top in standards. The UK approach combines high standards of corporate governance with relatively low costs, is proportionate, and is relatively prescriptive about how the company's board organises itself, according to a November 2006 publication, *The UK Approach to Corporate Governance*, by the Financial Reporting Council (FRC), which is responsible for corporate governance in the UK.

Clearly, corporate governance has made enormous progress since the business excesses of the late 1980s, including collapses such as that of Polly Peck, and frauds such as the plundering by Robert Maxwell, chairman of Mirror Group Newspapers, of his companies' pension funds (see Chapter 32).

The Cadbury Code

To combat such abuses, the Committee on the Financial Aspects of Corporate Governance was set up in 1991. It was also known as the Cadbury Committee, after its chairman Sir Adrian Cadbury, and was backed by the FRC, the London Stock Exchange (LSE) and the accounting profession.

In 1992 the Committee produced the Cadbury Report, which suggested a code of best practice applicable to UK-listed companies. The Cadbury Code, as this code became known, set a direction and standards for corporate governance.

The Code proposed that a company should be run by its board, which should be held accountable; that the roles of chairperson and chief executive should be separated; and that at least three independent non-executive directors should be on the board. Audit remuneration and nomination committees should comprise mainly non-executive directors, and there should be independent communication between non-executive directors and the auditors through an audit committee.

The reforms were mostly for listed companies, but were considered good governance guidance for any organisation. The Cadbury Code was not legally binding, but companies listed on the LSE were expected to 'comply or explain': that is, either follow the provisions of the Code or explain why they had not done so (see under 'Listing Rules' later in this chapter).

Since 1992, there have been regular additions to the Cadbury Report recommendations.

The Greenbury Committee

The next focus was on the high earnings of company directors in companies with a mediocre performance, an anomaly often highlighted in the press. In July

2005 the Greenbury Committee, led by Sir Richard Greenbury, produced a code on directors' pay, which focused on lack of transparency, including in share options. The committee set out to link pay with performance, recognising that high-calibre directors needed to be paid properly.

The Combined Code

In 1998 the Hampel Committee, under the chairmanship of Sir Ronnie Hampel, reviewed Cadbury and Greenbury. It put the case for continued self-regulation in corporate governance. This gave rise to the Combined Code on Corporate Governance, which has set out the main guidelines for UK corporate governance. The Code requires boardroom practice to be clearer and more formal, and it has taken corporate governance to investors (for more details, see under 'The Revised Combined Code' later in this chapter).

The LSE issued the Combined Code in 1998 as an appendage to the UK Listing Rules. On 1 May 2000, the Financial Services Authority (FSA) took over the LSE's role as UK listing authority, and administers the rules. Unlike Cadbury and Greenbury, the Combined Code separated the code of best practice into principles and provisions. Companies are required to state how they apply the principles and whether they comply with the provisions, and if not, why not. The procedure is known as 'comply or explain'. If a company takes a different approach from the Combined Code, it must explain this to shareholders, who must decide whether they are content with it, which means they must have the right information, and the right to influence the board.

The Turnbull Report

The Turnbull Report of 1999 provided guidance on internal controls to listed companies, superseding the Rutterman Report of 1994. Turnbull said that internal controls should be both embedded in an organisation's operations, and responsive to changing risks inside and outside the company. In October 2005, minor revisions to Turnbull were announced.

OECD Principles of Corporate Governance

In 1999 the Organisation for Economic Co-operation and Development (OECD), a Paris-based organisation of industrialised countries, created the OECD Principles of Corporate Governance, which were loosely based on the

Cadbury Report and others, and represented the lowest common standard acceptable to OECD members.

The principles were widely accepted as a benchmark. In 2002, they were revised for the purpose of providing further guidance, after consultation between representatives of OECD and non-OECD governments, businesses and other bodies.

The revised principles, approved in April 2004, aimed to rebuild and maintain public trust in companies and stock markets, and advocated greater transparency. They asked governments to ensure effective regulatory frameworks, companies to be accountable, institutional investors to become more aware, and shareholders to have an effective role in determining executive compensation.

In December 2006, the OECD announced it had released a methodology to facilitate the use of the principles, which could be used by independent assessors and for self-assessment. Unlike some existing schemes, it is focused on outcomes.

Directors' Remuneration Report Regulations

In August 2002, the Directors' Remuneration Report Regulations came into force. They aimed to improve disclosure and accountability to shareholders, and to enhance the competitiveness of listed companies by clarifying the link between pay and performance.

Under the regulations, listed companies are required to publish a report on directors' remuneration with their annual report and accounts. The report must contain details of individual director remuneration packages, the company's remuneration policy and comparative company performance graphs.

Directors have a personal obligation to provide relevant information, and must prepare, circulate and file the remuneration report correctly, failure of either being a criminal offence, punishable with a fine. Auditors must confirm that auditable information has been properly prepared. The company must put an annual resolution to shareholders on the remuneration report, but the result of the shareholder vote is advisory.

Higgs and Smith

The UK government asked Derek Higgs to report on the role of non-executive directors, whose role had come under renewed scrutiny after the Enron fraud (Higgs, 2003). Higgs liaised with the Smith Committee, established by the FRC

under Sir Robert Smith, which focused on the audit committee's role and the relationship between external auditors and the company that they audited (Smith, 2003). The Higgs and Smith reports were published together in January 2003.

Higgs said that non-executive directors should support shareholder interests, and have stronger communication lines with the company's main shareholders; at least half the board members, excluding the chairperson, should be independent non-executive directors; and non-executive directors should meet at least once a year without the chairperson or executive directors.

The Higgs report was controversial. Some non-executive directors have complained that it did not encourage investors to be sufficiently flexible towards corporate governance. Moreover, it required non-executive directors to be assessed regularly, but did not impose the same rule on executive directors.

Higgs suggested an expanded Combined Code, incorporating amendments on audit committees suggested by Smith, and the FRC started consultation.

The Revised Combined Code

The Revised Combined Code on Corporate Governance was published in July 2003, and applies to reporting years starting from November 2003. It made the Combined Code still more principles-based, and encouraged more transparency and greater shareholder accountability.

Under the Revised Code, all listed companies should have a nomination committee, whose members are mostly independent non-executive directors. Before a chairperson is appointed, their time commitment should be assessed, and no individual should chair more than one FTSE-100 company. The chairperson must ensure that directors receive timely information, and disclosure in the annual report is compulsory.

Executive directors should not have more than one non-executive directorship in an FTSE-100 company and should not chair one, according to the Code. The chairperson and chief executive should have separate roles, non-executive directors should be independent, and appointments to the board are made on merit. Directors' pay should be linked to corporate and individual performance, based on a formal and transparent procedure, and directors must not help to decide their own pay.

In financial reporting, the board is required by the Code to present a balanced and understandable assessment of the company's position and prospects. A system of internal controls should be maintained and reviewed annually. The audit committee should consist only of independent directors, and should make recommendations on the appointment and removal of external auditors.

Most of the revisions to the Code were in the detail. Probably the most significant new element was a requirement that the board should formally evaluate its own performance, following which the chairperson should take any action necessary. But some directors believe that evidence is lacking of the link between evaluation and greater effectiveness, and that too much attention is given to simplistic aspects of board performance, such as attendance at meetings, and not enough to less easily assessable aspects such as the commercial ability and ethics of directors.

In October 2005, Edis-Bates Associates published a survey of company secretaries' views on the Combined Code, intended to help the FRC in a review on its implementation. As many as 71 per cent of company secretaries who responded believed that the rules on evaluation were working, although in smaller companies they were less inclined to agree.

In January 2006 the FRC published a review in which it found that, since the introduction of the Revised Combined Code, there had overall been an improvement in the quality of corporate governance among listed companies, and a more constructive dialogue between boards and the company's main shareholders. This showed a lot more support for board evaluation than might have been expected in 2003, according to an FRC spokesperson.

In June 2006 the FRC published an updated version of the Combined Code, incorporating some minor changes. A further updated version was issued in June 2008.

Listing Rules

Under the Listing Rules, new applicants for a listing must ensure that directors are free from conflicts between corporate and personal interests, unless the company has arrangements in place to manage these conflicts. The FSA dropped a proposal made in October 2003 for an equivalent continuing obligation because the Combined Code and company law adequately covered these requirements.

Companies are required under the Listing Rules to include a statement in their annual reports on how they have applied the principles of the Code and whether they have complied with the provisions, and if not, why not. Under UK company law, shareholders have significant voting rights and can, under some circumstances, call an Extraordinary General Meeting.

The extract in the Listing Rules requiring companies to 'comply or explain' in relation to the Combined Code is shorter than the Code itself. 'But it is as important because it gives the Code its force,' says Chris Hodge, head of corporate governance at the FRC. The Model Code, an appendix to the Listing

Rules, is a code of conduct that aims to stop directors or employees of listed companies, and linked parties, from abusing, or placing themselves under suspicion of abusing, unpublished price-sensitive information. It applies especially in periods shortly before results are reported. In July 2005, the FSA simplified the Model Code as part of its revisions to the Listing Rules, extending it to persons discharging ‘managerial responsibility’.

The Myners Report

Following the Maxwell pension theft and subsequent legislative changes, pension funds came under scrutiny. The Myners Report, commissioned from Paul Myners by the Chancellor of the Exchequer, together with a set of voluntary principles for occupational pension schemes, was published in 2001.

The Myners report highlighted the need for greater transparency in how pension funds were operated and managed. Myners found that many pension fund trustees lacked the investment expertise to assess services sold to them by investment consultants and fund managers, and relied on a small number of investment consultants supplying bundled actuarial and investment advice.

Myners said that pension funds devoted insufficient resources to asset allocation, and unclear contractual structures created unnecessary incentives for short-termism in investment; there was insufficient focus on adding value through shareholder engagement. Myners said that pension fund trustees should voluntarily adopt best-practice principles for investment decision making on a ‘comply or explain’ basis, and only individuals with the right skills and experience should take decisions.

According to Myners, the performance of all advisers and managers should be measured, and trustees should assess their own performance. Trustees should engage with investee companies when it was in the interest of their fund members, and investment strategies and returns should be reported annually.

The government agreed that the Myners recommendations would benefit pension funds, consumers, industry and itself, and they went ahead. Subsequently in December 2004, the government reported that implementation had achieved only partial success.

HM Treasury asked the National Association of Pension Funds (NAPF) to undertake a further review of trustee compliance with the 10 Myners principles. NAPF found that in the new world of pensions some of these appeared less relevant, and recommended that the original 10 Myners principles be slimmed down to six higher-level principles, which cover the scope of the original principles. The Treasury has accepted the recommendation in principle, and detailed

implementation is currently being considered by an Investment Governance Group (IGG) under the chairmanship of the Pensions Regulator.

In addition, the NAPF concluded that overall standards of governance had improved and that trustees' compliance with the principles had increased. It found that shareholder engagement had increased and that pension funds were increasingly committed to it.

Developments across Europe

Most countries in Europe have a 'comply or explain' code. The concept of 'comply or explain' is now recognised in EU law in the Fourth Company Law Directive. This is a positive development if it means less demand for detailed regulation at the EU level, according to Chris Hodge at the FRC.

In many European markets, many companies have a majority shareholder, Hodge notes. 'There is arguably more justification for a regulator to take action to protect minority shareholders than over here where ownership tends to be more dispersed.'

In October 2007, Charlie McCreevy, European Commissioner for the Internal Market and Services, retreated from a campaign to give all EU shareholders an equal voice in running EU companies. He may have found it difficult to muster enough backing from EU member states and the European Parliament for the original 'one share, one vote' proposal. A study that McCreevy had commissioned in June found no evidence that a lack of shareholder democracy was a cause of a company's poor performance.

The financial crisis

The 2007–10 financial crisis has put corporate governance under scrutiny. The FSA has focused on governance in supervisory visits to financial services companies. Compliance and risk-management functions in firms have sought to be seen to implement best standards of governance. In particular, there has been public outrage about the short-term nature of the bonus structure in banks and how it may encourage reckless activity. There has also been criticism of the size of payouts to key executives. By early 2009, the UK government had bailed out Royal Bank of Scotland, but there was public outrage that RBS planned to pay £1 billion in bonuses and also a huge guaranteed pension for Sir Fred Goodwin, its chief executive.

The FSA published a consultation paper on pay deals in early 2009, and was expected to bring a new code into force in January 2010. It said in its paper

that banks, building societies and larger broker dealers should be required to establish and maintain remuneration policies, procedures and practices that both are consistent with and promote effective risk management. The provisions should apply to all employees of the firm. The FSA took the view that the principles in its February 2009 draft code on executive remuneration could be used as evidence of the promotion of effective risk management. The FSA was not trying to restrain remuneration levels. Lord Turner said in the *Turner Review*, a March 2009 report, that the major increases in capital required against trading book activity were likely to play a much more significant role in reducing the aggregate scale of trading activity and so reduce the aggregate remuneration of people involved in those activities, than any policies designed directly to influence remuneration.

The Walker Review

The Walker Review, published in July 2009, recommended a number of voluntary reforms to corporate governance of UK banks. The idea was that the review, by City veteran Sir David Walker, would later be extended to other financial institutions. The City responded favourably to the draft recommendations, which broadly supported the Combined Code, but looked at how it could be more closely observed. The Review took a big step forward on risk governance, with proposed scrutiny by the regulator for those who did not observe the recommended practices.

According to the Review, non-executive directors should properly understand a firm in order to challenge the executive directors effectively. They had to understand the risks and the risk management strategy. Walker said that non-executives should have more support, including access to external expertise and training, and should put more time into the job. They should all be capable of looking critically at big strategic issues.

Non-executives would not have to be alone in keeping risk under control. According to the Walker Review, there should be a board-level risk committee, separate from the audit committee, with access to expertise. The risk committee's annual report should be included in the company's annual report. Walker suggested the CEO could be excluded from the risk committee so it could have open discussions without the CEO's sometimes dominating presence. The committee would advise the remuneration committee on risk measures to be included in the pay range of executives, with a focus on future as well as current risks.

Separately from the risk committee, the chief risk officer should have a more significant role, reporting into the chief executive or finance director, and with direct access to the chairman.

In addition, the Walker Review said that institutional investors had a ‘duty of stewardship’ under which they should actively engage with the board of companies in which they invested. Walker acknowledged that not all investors would be willing to engage, but suggested that FSA-authorized fund managers who were unwilling to commit publicly to shareholder engagement should have to explain why. Walker suggested that, if the share register should change hands over a short period, the FSA could contact selling shareholders.

In October 2009, the Association of Chartered Certified Accountants (ACCA) said in its response to the consultation on the Walker Review that the 39 recommendations included would not tackle the problems of banking governance failures since they were based on a wrong assumption that shareholders could and would provide sufficient influence over corporate boards to ensure good performance.

In addition, ACCA disagreed with the Review’s case that the core objective of a bank or other financial institution was the successful arbitrage of risk, saying that if the banking system was to continue to rely on taxpayer support, or the promise of it, the purpose of banks should include an ethical responsibility to society, and governance systems should aim to ensure this requirement was met.

The 2009 Review of the Combined Code

In March 2009 the FRC announced the latest in its series of reviews of the Combined Code. The Council was working closely in cooperation with Sir David Walker and sharing research and evidence, but it was conducting its review separately from his. A revised code would take effect in mid-2010.

The FRC review raised questions about corporate governance in relation to the Combined Code, and it received a wide range of responses. At one extreme, Prudential said in its response that the financial crisis of the time was not primarily a corporate governance failure in the commercial world at large. The group put much of the blame for the crisis on regulators, central banks and policy. At the other extreme, the ACCA said that it considered corporate governance failures chief among the various failures blamed for the current economic crisis.

Risk management was an area that respondents said needed extra focus. The Association of Insurance and Risk Managers and the Institute of Risk Management said it was appropriate for the Combined Code to contain further

information, guidance and advice on the need to establish risk management systems within an organisation.

Aviva said that it was very difficult for shareholders to assess what are effective risk management practices. They would be more reassured, however, if reporting was more bespoke, with examples of how known and ‘known unknown’ risks were captured and dealt with. Responsibility for risk should lie with the whole board rather than an individual board member. There might be merit in considering a review and update of guidance for audit committees covering disclosure around audit, risk and the effectiveness of internal controls. Aviva also recommended that the Combined Code should give greater prominence to ethics.

According to the FRC in July 2009, the industry’s response to the review to date found that the Combined Code and its predecessors had contributed to clear improvements in governance standards. Many considered at least some of the perceived shortcomings in governance in banking to be sector-specific. In addition, there was recognition that the quality of corporate governance depends on behaviour not process, so there is a limit how far any regulatory framework can deliver good governance.

Respondents to the review preferred to keep the ‘soft law’ approach underpinned by some of the regulation rather than an approach more reliant on legislation and regulation. The view was that some parts of the Combined Code needed further review and possibly revision, but there was no need for a complete overhaul. Companies and investors both expressed reservations about how ‘comply and explain’ works in practice. The view was that it was crucial there should be enough institutional investors willing and able to engage actively with the companies in which they invest.

The future

The UK system of corporate governance remains well respected. However, as FRC chief executive Paul Boyle said in a July 2009 speech at the Council’s annual open meeting, the continued viability of the “comply and explain” approach depended on the willingness of enough institutional investors to actively monitor the corporate governance practices of companies in which they invested (Boyle, 2009: 3).

How strong the will is for good corporate governance remains disputed. McKinsey’s Global Investor Opinion Survey on Corporate Governance, a widely quoted piece of opinion-based research, found in 2002 that 78 per cent of Western Europe-based investors would pay a premium for a well-governed

company, down only slightly from 81 per cent in 2001 (McKinsey, 2002, exhibit 3; refer to exhibit 1 for full survey question).

Other studies have supported this finding but scepticism lingers, not least because of the subjective nature of data in opinion-based research. Nonetheless, the financial crisis of 2007–10 has boosted the perception that corporate governance is important. With crisis comes opportunity.

Accounting and governance issues

Introduction

In this chapter, we shall focus on accounting and governance. We shall consider the widespread impact of the Sarbanes–Oxley Act. We consider developments in EU auditing and disclosure rules, and the business review required by the Accounts Modernisation Directive. We shall see how International Financial Reporting Standards have made accounting more transparent. Read this together with Chapter 26, which provides an overview of corporate governance.

Accounting scandals

Corporate governance has gained a higher profile after major accounting scandals. In June 2002 WorldCom, a US telecoms group, revealed a US\$11 billion accounting fraud, and a month later it filed for Chapter 11 bankruptcy protection.

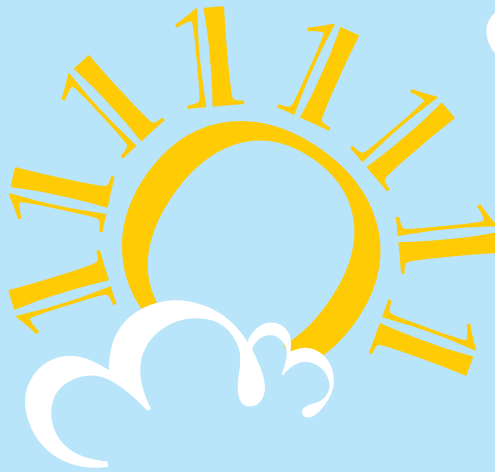
Enron, a US energy company, went bankrupt in December 2001, and in May 2006 former Enron bosses Ken Lay and Jeffrey Skilling were found guilty of fraud, conspiracy and other charges. They had both pleaded not guilty and had denied knowledge of fraud schemes, putting the blame on junior managers.

In December 2003 Parmalat, the Italian food and milk products company, almost defaulted on a small bond issue. Shortly afterwards, it was discovered that the group had falsified its accounts to conceal losses and that substantial sums had been embezzled, mainly by Calisto Tanzi, the group's former chairman and chief executive.



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The Sarbanes–Oxley Act

The US Congress phased in the Sarbanes–Oxley Act 2002 shortly after the Enron fraud as an emergency piece of legislation, based on reforms agreed with the New York Stock Exchange. The Act, named after its authors, Democrat senator Paul Sarbanes and Republican congressman Michael Oxley, sets standards for the boards, management and external accounting firms of US publicly listed companies.

The Act met the recognised need for stricter auditing controls. At Enron, the Arthur Andersen team in charge of the company audit was found to have destroyed documents to conceal the truth, which showed a need for greater controls.

Sarbanes–Oxley aims to reinforce the independent status of external auditors, and requires procedures that stamp out creative accounting. Financial reports should be auditable and supported by data, tested for alteration, with systems in place to detect this.

Under Sarbanes–Oxley, accountants cannot mix auditing with certain other business activities, including actuarial or legal services, and bookkeeping. In the United States, auditors are supervised by the Public Company Accounting Oversight Board (PCAOB), which is answerable to the Securities & Exchange Commission (SEC), the US regulator of financial markets. They are required to maintain audit records for five years. Failure to comply may be punished with a fine and up to 10 years' imprisonment. The company's audit committee must pre-certify all other non-audit work.

Under the Act, significant extra disclosure is required in the annual report and accounts, as well as ethical guidelines for senior financial officers. Guidelines are required on analysts' conflicts of interest. There is a ban on personal loans to executive officers and directors. Accelerated reporting of trades by insiders is required, with no such trades allowed during pension fund blackout periods. The Act increases corporate responsibility for any fraudulent actions taken, and there are criminal and civil penalties for securities violations.

The chief executive and chief financial officer must sign off financial statements to confirm compliance with the provisions of the Securities Exchange Act 1934. If the statements turn out to be incorrect, the signatories could be held criminally liable under Sarbanes–Oxley, even if they had not intended deceit. They could receive a fine of up to US\$1 million and up to 10 years' imprisonment. If they certified the inaccurate statements wilfully, the fine could be US\$5 million, and the prison sentence 20 years.

Sarbanes–Oxley requires organisations to introduce adequate controls over their IT systems and assess their adequacy annually. To assist the process of

justice, whistleblowers are protected. Civil penalties are added to disgorgement funds to relieve victims.

US listings have become less attractive to foreign companies as a result of Sarbanes–Oxley, and the London Stock Exchange has attracted listings from companies that might have previously chosen the New York Stock Exchange. Sarbanes–Oxley applies to those companies that issue securities in the United States, which includes about half those included on the UK’s FTSE-100 Index. It also applies to companies that own a US subsidiary or are required to file reports with the SEC. The company’s physical location is not significant, although the national rules of a non-US country will prevail should they conflict with the Act.

By early 2007, the United States started to soften some of the Sarbanes–Oxley requirements. In March 2007 the SEC published new rules for deregistration by foreign companies, adopted that month, which eliminated conditions that had been considered a barrier to entry. Until this point, a foreign issuer could only have exited the registration and reporting regime required if it had fewer than 300 resident shareholders, which was a difficult requirement for a foreign issuer to meet given the increasing globalisation of financial markets.

From March 2007, the criteria for exiting this regime changed. The main condition for allowing exit now is that the US average daily trading volume of the securities has been no greater than 5 per cent of the average worldwide trading volume for a recent 12-month period. The SEC said that the amended rules would encourage participation in US markets and increase investor choice. In April 2007, SEC commissioners endorsed measures to improve Sarbanes–Oxley implementation to ease small company burdens.

There is some transatlantic crossover, and many of the non-contentious parts of Sarbanes–Oxley have for a long time been part of UK law. ‘In some respects, UK legislation is tougher than the US,’ says Chris Hodge, head of corporate governance at the Financial Reporting Council (FRC). ‘US shareholders would love to have the same rights as their UK counterparts.’

In the United States, enforcement powers rest with the SEC, which tends to be more rule-based, as regulators have to be seen to be consistent, Hodge says. ‘In the UK, we can build in more flexibility because the power rests with the shareholders and the market.’

Given the financial crisis of 2007–10 with the US government’s bailout of AIG and the collapse of Lehman Brothers, critics are saying that Sarbanes–Oxley has not worked well. They say it failed to prevent bad oversight of risk by financial institutions.

European auditing and disclosure rules

The European Commission has said it sees no need for a single corporate governance code across the European Union, and that in most cases, rules should be left to each member state. But it has introduced some common requirements to be implemented.

In April 2006, the EU Council of Ministers adopted the Statutory Audit Directive, which aims to enhance confidence in the financial statements and annual reports published by companies across the European Union. It replaced the Eighth Company Law Directive, which had been updated to prevent audit scandals such as Enron and Parmalat, and amended the Fourth and Seventh Company Law Directives.

The Company Reporting Directive also amends the Fourth and Seventh Company Law Directives, as well as the Bank Accounts Directive and the Insurance Accounts Directive. The two directives came into effect on 29 June 2008 for financial reporting periods starting on or after that date. Let us look at each directive in more detail.

The Statutory Audit Directive

This requires publicly listed companies to have an audit committee that meets certain requirements, or an equivalent body. This must have at least one independent member and a member competent in auditing and accounting. Firms must create the committee and describe how it is composed. The FSA has not been prescriptive in this area, which gives firms some flexibility. The regulator has made it clear that shareholders play a role in creating and maintaining a company's governance.

According to the Statutory Audit Directive, registration is required for every third-country auditor providing an auditor report on the accounts of a company that is incorporated outside the European Economic Area (EEA), but whose shares are traded on an EEA-regulated market. There are implementation challenges because the European Commission has not yet decided on the equivalence of third-country auditors. There are 36 transitional countries, including the United States and Australia, as well as, for example, Russia and the United Arab Emirates. The European Commission has taken the position that transitional country auditors can audit accounts for financial years between 29 June 2008 and 1 July 2010, subject to certain conditions.

The Company Reporting Directive

The Company Reporting Directive introduced a new requirement for listed companies to produce a corporate governance statement in their annual reports.

Business review

Financial statements do not meet all the information needs of users. In 1992, the Cadbury Committee concluded that shareholders needed a coherent narrative of a company's performance and prospects, which could be provided by a forward-looking operating and financial review (OFR).

The OFR became a statutory requirement for all UK-listed companies to publish for financial years starting on or after 1 April 2005. It was an implementation of the EU Accounts Modernisation Directive, which requires large and medium-sized companies to include a business review in the directors' report, which is part of the annual report and accounts.

On 28 November 2005 Gordon Brown, then chancellor, announced a surprise intention to remove the requirement to publish the OFR because the business review, required by the Directive, shared most of the same major requirements, and government policy was not to impose regulation on UK businesses above the relevant EU Directive requirements.

The business review puts less of an onus on firms than the OFR to give information about the future, and there is less clarity on how far it requires owners to understand the strategy of the business, but many of the requirements remain the same.

The Reporting Standard on the OFR has given way to a Reporting Statement of best practice, which is voluntary. The guidance in this statement is more specific than required in legislation, particularly on forward-looking information.

Under the Companies Act 2006, which received Royal Assent on 9 November 2006, there were further provisions in relation to the business review. It would be given a statutory purpose, which was to inform the shareholders of the company and help them to assess how the directors had performed their duty under the Act, and to promote the success of the company.

The Act would require quoted companies to provide additional disclosures, as far as the directors judged necessary to understand the business, including the main trends and factors likely to affect its future development, information about environmental and social issues, and the company's employees. Directors would have some protection from liability for statements or omissions in, among other segments, the directors' report.

International Financial Reporting Standards

For financial years beginning on or after 1 January 2005, International Financial Reporting Standards (IFRS) came into force for the consolidated accounts of all listed companies in the European Union, and they have since been spreading

worldwide. Companies quoted on the Alternative Investment Market have had to prepare their accounts in accordance with IFRS for periods beginning on or after 1 January 2007.

The rewards of IFRS are that accounts should reflect economic reality and that the uniformity of accounting should lead to cost savings for international groups. In making the transition, the financial statements became longer, but resources committed to producing them did not proportionately increase. Industry feedback suggests that many companies have tended to use boilerplate descriptions for certain disclosures.

Under IFRS, the cost of stock options estimated at the date of grant has been included as an expense on the income statement for the first time in many jurisdictions, such as the United Kingdom. Goodwill must be recognised and tested annually for impairment, and there must be significant disclosure of key assumptions and sensitivities. Valuing of intangible assets, such as brands, has proved more complex than anticipated, according to accountants.

Dividends are no longer accrued, unless they are declared before the year-end. Deferred taxes are calculated on revaluations, as well as on timing differences, and feedback suggests that this broad area of accounting has been challenging. The options for recording actuarial gains and losses have also led to complexity and reduced comparability.

Among other changes arising from IFRS, pension deficits now appear on the balance sheet and must be valued, with key assumptions disclosed. Changes in value to investment property must now be in the income statement.

The classification of leases into operating or finance accounts has had to be reassessed. Hybrid securities, such as preference shares, are classified as debt rather than equity as has been done previously, because there is a focus on the substance of the transaction, which in this case may more aptly resemble a debt instrument. Derivatives must be put on the balance sheet at fair value and marked-to-market through the income statement.

The 'fair value' reporting requirement can lead to much more volatility on the income statement arising from the periodical valuation of financial instruments, including derivatives. Fair value can lead to an overstating of values and profits when markets are rising, but equally to overstating the declines in value on the way down, as noted in *Fair Value*, a policy paper published by the Association of Chartered Certified Accountants (ACCA) in February 2009. This has led to criticism, according to the paper, that fair value adds to so-called procyclicality by amplifying the effects of the business cycle.

Among the specific concerns around fair value reporting, highlighted by the credit crisis which started in 2007, is the issue of how to value instruments when there is no genuine market to which to mark, as had been the case for

many of the complex financial instruments used by financial institutions to diversify risk. In this case, models based on subjective and hypothetical assumptions had been used to arrive at a fair value.

Meanwhile, the ACCA still believes that fair-value accounting, as part of IFRS, is the best way. In May 2009 Veronica Poole, leader, UK, IFRS Centre of Excellence at Deloitte, said that fair-value accounting had been the messenger warning of the credit crisis, and it did one good thing in that it highlighted its existence, bringing into focus that values were falling.

Accountants are clear that accounting in itself is not responsible for the problems arising from the writedowns – rather, it valued them by a certain set of criteria. The writedowns are real. The April 2009 issue of the International Monetary Fund's *Global Financial Stability Report* estimated that writedowns on global exposures to bad assets could reach US\$4 trillion, of which two-thirds fell on banks, but up to that point, banks had recognised less than a third of their estimated losses.

By the end of 2009, there is likely to be a new IFRS on consolidation accounting. This will introduce considerably more transparency around structured vehicles, as were used in shadow banking before the financial crisis of 2007–10, and will discourage financial engineering. A US initiative with broadly the same disclosure requirements is running in parallel.

Moves to bring about convergence between IFRS and US Generally Accepted Accounting Principles (GAAP) made some headway in 2009. Much work remains. US GAAP and IFRS have different approaches on, for example, some areas of fair-value accounting and in the area of impairment. Convergence takes a while because IFRS and US GAAP start from different points. The underlying framework is important as well as the words in the standards. By mid-2009, the European Commission had put pressure on the International Accounting Standards Board to achieve convergence for IFRS with US GAAP on a piecemeal basis. Europe is a crucial member of IFRS, and could walk away from it and write its own standards.

The FRC is calling for simplification of IFRS. In his remarks to the FRC's annual general meeting in July 2009, FRC chief executive Paul Boyle queried whether it was desirable that IFRS should contain 23 different probability thresholds such as *probable*, *more likely than not*, and *reasonably certain*.

Insurance and the London companies market

Introduction

In this chapter, we shall focus on insurance and how the London companies market is made up. We shall see how underwriting works, and examine the impact on insurance of world events such as terrorism, as well as regulatory developments. Read this in conjunction with Chapters 29, 30 and 31.

Insurance overview

Insurance is a service that offers financial compensation in return for a premium payment should an adverse event occur. In an insurance transaction, one party, the insurer, undertakes to pay another party, the insured, if a specified form of financial risk should arise. For this service, the insured pays the insurer a fee, known as a premium. The insurer insures its own risk by placing reinsurance with a reinsurance company (see Chapter 30).

Today the Financial Services Authority (FSA) regulates and supervises the UK insurance and reinsurance industry, including brokers, along with the rest of the financial services industry. The UK insurance regulatory model is considered more coherent than the US model, where individual states are involved.

As a broad generalisation, the FSA is more willing to stand back from wholesale than retail insurance. For consumers, it sees motor insurance or household insurance sales as less of a problem than sales of protection products.

UK market share

According to a December 2009 insurance report by IFSL (Maslakovic, 2009d), the UK insurance industry remains the largest in Europe and the third largest in the world. New worldwide premiums of the UK insurance market grew by 3.4 per cent in 2008 to reach US\$4.3 trillion. For the first time in the past three decades, premium income declined in inflation-adjusted terms, with non-life premiums down by 0.8 per cent and life premiums falling by 3.5 per cent.

The financial crisis showed that the insurance sector was sufficiently capitalised. New worldwide premiums of the UK insurance market fell 18 per cent in 2008 to £215.3 billion, a decline which was due to a 23 per cent fall in long-term premiums to £168.1 billion. General insurance premiums rose, however, by 8 per cent in 2008 to £47.2 billion, mainly due to an increase in overseas business.

The insurance industry has been concerned that it should not suffer from a regulatory backlash arising from the financial crisis which would be directed primarily at banks, but take it in as well. Trade bodies such as the CEA, the European insurance and reinsurance federation, and in the United Kingdom the Association of British Insurers (ABI) and the International Underwriting Association (IUA), have battled to make sure the insurance industry is still seen as distinct from the rest of the financial services industry. The case is that insurance is a different model from banking and did not contribute similarly to the credit crisis.

Insurance may be categorised under three broad headings: general insurance, life and pensions, and health and protection. According to the ABI, there are 1,017 insurance companies authorised by the FSA to carry on insurance business in the United Kingdom. Of the total, 762 do only general business, which is insurance of non-life risks such as motor, household and commercial insurance, where the policy offers cover for a limited period, usually a year. A further 209 insurers are authorised specifically for long-term business (such as life insurance and pensions), and the remaining 46 insurers carry out both general and long-term business.

The top 10 general insurance groups account for 71 per cent of business written, and the top 10 life and pensions insurance groups account for 80 per cent. In 2007, total net premiums (written premiums less reinsurance premiums paid by the insurer) were £32.9 billion, of which the largest proportion was motor, at £10.5 billion, with motor claims paid of £8.2 billion, followed by property at £8.6 billion, with property claims paid of £6.7 billion.

London

The London market covers general insurance and reinsurance business, and is the only place in the world where all 20 of the world's largest insurers and

reinsurers have offices. London is a 'leading' market, setting the rates and providing the intellectual capital for risks written elsewhere. It is one of the leading providers of insurance and reinsurance to the United States, the world's largest insurance market.

The London market is split between the company market, which consists of insurance companies, and Lloyd's, which consists of syndicates (see Chapter 29). Most of the companies are members of the IUA. The insurance company market grew in the 1970s as foreign insurers opened City offices. The London market now employs about 40,000 people in London and another 10,000 employees in the United Kingdom.

AIG

The insurance industry feels it has been unfairly tarnished by the derivatives trading of a few insurance companies, in areas outside traditional insurance, which led to exposures in toxic assets during the credit crisis. Swiss Re had some losses in this area, but the biggest loser was American International Group (AIG). The problems at AIG arose in its financial products division in Mayfair, London, where the company used its high credit ratings to write credit default swaps (CDSs) for a fee. The CDS industry was largely unregulated, and AIG was not required to have reserves to meet potential claims. AIG saw its financial products division's business in this area as largely free from risk, and did not subject it to group risk management. This proved a mistake when sub-prime mortgages fell into default and the trading of complex derivatives imploded. At the end of 2007, AIG's accounts changed the basis for valuing some collateral, and there was a significant mark-down of CDSs written by AIG's financial products division.

According to the 2007 annual report and accounts, AIG Financial Products had not hedged its exposure to a fall in CDSs. As the value of assets underlying the CDSs that AIG had written for asset-backed securities and collateralised debt obligations fell, AIG wrote down its position. In September 2008, credit rating agencies downgraded AIG and the group had to post extra collateral with its trading counterparties. The insurer needed extra liquidity. Shortly after, in the same month, the US government committed itself to lending up to US\$85 billion to AIG in return for a 79.9 per cent equity stake in the insurer in the form of warrants called equity participation notes. Late in 2008 the rescue package was increased to US\$150 billion, and by early March 2009 the bailout was extended to offer AIG an additional US\$30 billion in equity.

London has both non-Lloyd's brokers, and Lloyd's brokers. Most of the larger brokers are in both categories, and London is a broker-led market. Acquisition costs, consisting of brokerage and commissions, are by far the biggest part of the expenses in the Lloyd's profit and loss account.

More about the London market

The London market covers a high proportion of very large or complex risks. There are three main types of business: (1) marine, aviation and transport, known as MAT; (2) home–foreign, and (3) non-MAT treaty reinsurance.

The London market's MAT business developed from Lloyd's marine underwriting, and Lloyd's does more than half of this business. Home–foreign business covers writing risks from London that are outside the United Kingdom. This type of business is roughly split between two-thirds from Lloyd's, with most of the rest from insurance companies and some from protection and indemnity (P&I) associations (see discussion below). Non-MAT treaty reinsurance is for general risks – that is, non-transport – of which insurance companies do around two-thirds, and Lloyd's the remainder. For an explanation of treaty reinsurance, see Chapter 30.

In marine insurance, London has the largest share of premiums in the world. According to the IFSL (McKenzie, 2009b), the UK insurance market in 2008 had a 16.7 per cent share of global marine insurance premiums, putting it first, ahead of Japan, the United States and Germany.

Insurance companies and Lloyd's are both involved as marine underwriters, covering such classes of business as cargo insurance, indemnifying the policyholder against loss of goods; hull insurance, which covers the ship's structure; war risks; building risks; specie (valuable risks); rigs (exploration rigs and oil production platforms); yachts; docks; incidental non-marine; and inland marine.

For marine liability coverage, there is some mutual pooling of risks by ship owners. Protection and indemnity associations, known as P&I clubs, are mutual insurance cooperatives that were created to serve the marine industry. They mainly insure their members against risks not covered by the Lloyd's or marine companies' policies, including collision damage and liabilities for loss or damage to cargo, pollution, loss of life or personal injury on ships, and collision liability.

P&I clubs are wholly owned by the ship owners, which makes them both insurers and insured. Unlike companies, they actively help the ship owners manage their risks. They advise on contracts and provide legal help in claims. According to *Maritime Services 2009*, a report published by IFSL Research, the United Kingdom had a leading 62 per cent of global P&I insurance, down from 67 per cent in 2007, and accounted for by its P&I clubs.

The International Group (IG) of P&I Clubs is a legalised, non-competitive cartel based in London, which consists of 13 not-for-profit insurance organisations providing coverage for over 90 per cent of the world's ocean-going tonnage. Clubs are individually liable for claims up to US\$6 million, above which claims are shared between the 13 group members. There are some other P&I insurers, both mutual and commercial, outside the IG, which tend to cover smaller vessels.

The United Kingdom is also a leading source of aviation insurance, where it has about a quarter of the treaty reinsurance that is internationally available.

Underwriting

The London market, whether the insurers are companies or Lloyd's syndicates, works as follows. A broker seeks insurers for specific risks, and must find a 'lead' underwriter who will accept the first share, perhaps 25 per cent of the risk, and so establish the policy terms, and then find 'following' underwriters who will subscribe on this basis. This risk syndication can be spread across anything from one or two to 10 or more companies or syndicates on each risk, with great variations across different classes of business.

Underwriting remains dependent on human judgment. Reliance on models in this industry, as in banking, can be misplaced; in various events, it has demonstrably underestimated the likelihood of catastrophes and the size of the impact. The 2005 hurricane season was active, with Hurricane Katrina causing an estimated US\$81 billion of losses. In 2006, in response to the previous year's major hurricanes, providers of catastrophe models explicitly built into their products the effects of climate change.

Some underwriters will take more risk than others, but their approach should be consistent with the risk appetite of the firm for which they work. The quality of underwriting may vary according to information received, advice taken and risk modelling, as well as the type and amount of business taken on, premiums payable and reinsurance terms. Market conditions play a part.

There is an insurance cycle, and to manage it is a major part of the underwriter's job. In the part of the cycle called a hard market, insurance rates rise because demand exceeds supply and profits tend to accrue, attracting extra capital into the market.

As the supply increases again, it creates a soft market, where insurance rates fall, and lead insurers focus on market share rather than profit. Underwriters may look to write business that is loss-making in the short term. The FSA has said it understands this approach, but a disciplined and well-managed environment is needed to achieve such an outcome.

A major disaster will lead back to a hard market. Insurance rates will rise, particularly in those classes of business most affected by the disaster. After the

11 September 2001 terrorist attacks on the United States, aviation rates in particular hardened, and after Hurricane Katrina in 2005, energy reinsurance rates hardened.

Classes not directly affected may also see some level of rates hardening because the supply and demand ratio changes, but other factors may limit the impact. If rates had been softening, a major event might typically slow the trend, but not entirely reverse it.

The industry may welcome a hardening of rates, which has a positive impact on the combined ratio, calculated by taking losses and expenses as a percentage of premiums received, but excluding investment income. If the combined ratio is 99 per cent, the insurance company will have made a 1 per cent underwriting profit. If it is higher than 100 per cent, there will be an underwriting loss, but the overall position may be profitable after allocated investment income has also been taken into account.

Regulatory developments

Contract certainty

In the past, insurance deals have been struck but the paperwork has sometimes not been sorted out for some months, which led to contract uncertainty. The problem became apparent in the insurance demands arising from the 11 September 2001 attacks on the United States.

In December 2004, John Tiner, then chief executive of the FSA, said the FSA wanted to see the end of a practice which was 'deal now, detail later'. He said that the regulator wanted to see greater certainty at inception of the contract, with full policy documentation to follow promptly. The FSA gave the London market two years to find a solution that would bring contract certainty. By November 2006 Lloyd's managing agents were reporting 91 per cent of contracts as certain at inception and some insurance companies were reporting even higher levels.

The FSA took the risk of attesting that the industry had succeeded, but said that the process had to be ongoing. Clearly, as in this and some other cases, financial markets can be trusted to find their own solutions. Views remain divided on how far the regulator should stand back.

Contingent commissions

Contingent commissions arise when insurers pay commissions to brokers in exchange for steering business their way. In April 2004 New York Attorney

General Eliot Spitzer launched an investigation into this area, and later alleged that certain brokers had taken pay-offs from insurance providers in return for introducing clients, with the result that the clients were denied best prices for policies. Spitzer alleged that bid rigging had taken place, which is where the broker makes sure that a favoured insurer wins the business.

During 2005, a small number of brokers agreed to pay substantial fines to settle charges initiated by Spitzer, including bid rigging, but many neither admitted nor denied the allegations. Spitzer said that there would be further investigations across the industry.

Within weeks of Spitzer's allegations, seven global insurance brokers announced that they would stop contingent commissions, and by early 2005 they were presenting revised business models. But others continued the practice. There was widespread feeling in the insurance industry that Spitzer's actions were politicised.

There is some high-level industry sentiment that there is nothing wrong with contingent commissions provided that there is disclosure. The FSA has not yet made automatic disclosure of brokers' commissions mandatory in the United Kingdom, which fits with its preference for avoiding prescription, but the issue is under discussion.

ICAS and Solvency II

The FSA has required insurers to match capital closely to the risk of business written. Individual Capital Adequacy Standards (ICAS) are the framework under which firms measure their own risks to calculate the capital needed and the regulator reviews the results. The regulator gives firms Individual Capital Guidance, specifying the capital it thinks they should have.

ICAS is a move in the direction of the EU Directive, Solvency II, which will be applied to the London market, as part of the European Economic Area, in 2012. Through Solvency II, firms will have much greater freedom to calculate their own capital requirements for regulatory purposes. With this freedom comes responsibility. As Paul Sharma, head of financial risk review and modelling at the FSA, has made clear on the conference circuit, the Directive will make more demands on the insurance industry than ICAS. The idea is that the introduction of new qualitative requirements under Solvency II, including risk management, should make insurance failures less likely. Under the new regime, insurers will be able to invest in any asset they wish, provided they can show they understand the risks involved and can manage them.

The Solvency II framework requires insurers, as under ICAS, to establish technical provisions to cover expected future claims from policyholders. In addition, insurers must have resources to cover both a minimum capital

requirement (MCR) and a solvency capital requirement (SCR). The SCR is based on a value-at-risk (VaR) measurement, similar to that used for the banking industry under Basel II regulations (see Chapter 8 on the application of VaR to derivatives). The VaR aims to set a maximum loss that may be expected with a given probability over a specified time. The banking system considers a single day VaR, but the SCR calculation considers a year. The probability is 0.5 per cent, meaning a 1 in 200 chance event. It can be difficult to assess what is a 1 in 200 event, and the practice can vary from the statistical distribution, as banks found in their models. This challenge is compounded in extreme situations. If there is little or no statistical data, there is guesswork involved.

Critics say that VaR is entirely discredited and so this makes Solvency II flawed. Defenders of VaR say that it was not intended to enable zero-failure and it is over-reliance on the VaR that caused the problem in banking. They say that VaR is useful in that it provides an impartial assessment of both total risk and individual risks facing the business, and requires an understanding of the impact that complex securities, such as collateralised debt obligations, could have on the balance sheet.

Compromises to Solvency II have already been agreed. The United Kingdom, France and Germany were disappointed when the concept of group support, which they had seen as a cornerstone of Solvency II and its risk-based principles, was excluded from the directive. This was as called for by Spain and some of the newer EU accession states. The Commission is committed to having the new requirements in place in 2010, at least 18 months before insurers will need to start applying the new rules.

A stepping-stone towards Solvency II has been the Reinsurance Directive (see Chapter 30).

Block exemption requirement

In 1992 the European Commission recognised that insurers should have block exemption from competition rules because some cooperation, although it could be seen as anti-trust, was appropriate for the insurance industry. Subsequently the Commission exempted insurers by allowing them to cooperate on the calculation of pure premiums, extending this to standard policies and conditions, and also allowing additional pools to be created.

In 2008 the European Commission was saying that it might not renew the insurance block exemption requirement (BER), which covered these exemptions. It was concerned about anti-competitiveness, and also that insurers had taken exemption within limits to mean 'blanket' exemption. Given this situation, insurers found it hard to convince the Commission of their case that they needed the BER for legal certainty. There was a year of fighting until in 2009, the Commission made it clear that it would renew the BER by about March 2010, but with some qualifications.

The Commission said there was no need for exemption when insurers discuss standard conditions. From now on, insurers would have to cooperate on setting up standard policy conditions. Insurers would be allowed to cooperate on pure premium calculations, but the data should now be accessible to consumer organisations. Pools would continue to be exempt, but this would be subject to much more stringent requirements. The market share of the pool itself should include cover outside the pool, which made it higher. Coinsurance or coreinsurance pools, such as nuclear or environment, had to be distinguished from ad hoc insurance pools, where joint capacity in different insurers provided coverage, and which would be subject to anti-trust rules. The European Commission had no problem if the leader among various insurers providing cover on one policy set the price, but alignment of premiums remained a concern.

The insurance industry, including the London market, saw this partial renewal proposal as good news in the main, although it had reservations about some of the compromises. Failure to renew the BER would have caused problems, particularly to smaller insurers, which could not gain access to the standard data that they needed to enter markets.

The future

As an insurance centre, London has significant underwriting expertise, diversity of business and a reputation for innovation. It has access to back-up specialists such as lawyers, consultants and claims adjusters, and provides the best expertise in interpreting contractual clauses for settling claims.

For such reasons, London constantly attracts new capital. But its share of the global commercial insurance market has declined since the 1990s, and in some sectors even earlier. Since the turn of the millennium, the insurance market in Bermuda has grown at a rate almost seven times that of London. Market sources attribute London's relatively slow performance partly to the greater cost of doing business in London, and the rate of corporate tax (in Bermuda there is none), as well as to the lack of efficiency and clarity in its processes.

London hopes that market reform initiatives will keep the London insurance market ahead in the face of competition from Bermuda, New York, Qatar and other locations.

Market reform

The Market Reform Group, including representatives from both Lloyd's and company markets, acts as a focal point for setting the direction of the current market reform programme, which is basically about electronic efficiency. In

September 2009, it was renamed the London Market Group, and under its new name its remit was broadened to include any aspect of business that would benefit from a cross-market view.

The London market has always put, and still does put, an emphasis on face-to-face activity. With market reform as undertaken by the London Market Group, the more mechanical tasks are done electronically, freeing up underwriters and brokers to focus on the more complex work. Under the reform initiatives, data is supplied electronically for face-to-face negotiations. Claims are agreed and processed, and accounting is done electronically. Electronic placing is the most ambitious of the changes and has required a cultural change. There are electronic solution endorsements for some aspects, which could be, for example, a change in address, avoiding a need to walk around the market to see the underwriter.

In these initiatives, the London Market Group aims to bring everyone in the market together, and is made up of CEOs across the market, including Richard Ward, CEO at Lloyd's, CEOs of market firms and heads of trade bodies. The group coordinates and communicates industry activity across the market. The FSA had set the market a challenge to end the 'deal now, terms later' contracts, and the Group had helped to achieve this. Another reason for the regulator's interest in the Group's work is that it addresses operational risk.

Insurance: Lloyd's of London

Introduction

In this chapter, we shall focus on Lloyd's, which is part of the London insurance market. We examine the history of Lloyd's, how the market works, and the chain of security that underpins it, as well as the centralised underwriting controls.

Overview

Lloyd's is a specialist insurance market, representing over half of the London insurance market, including reinsurance (see Chapter 30). Business flows into it from more than 200 countries and territories worldwide. Lloyd's started as Edward Lloyd's Coffee House, a 17th-century coffee house where timely shipping news was made available and marine insurance could be obtained.

Shipping and insurance were closely connected, and ship owners would meet in the coffee shop with wealthy individuals who took the risk of insuring ships and cargo. These were the early underwriters, and they had unlimited liability, which meant that they had to meet claims even if these bankrupted them. They were called Names because they put their name on a slip of paper, the forerunner of today's underwriting slip, indicating what percentage of risk they would bear in return for a pro rata cut of the premium.

In 1769 the shipping insurance community moved to another coffee house, separating itself from other business, and kept the Lloyd's name. In 1811 Lloyd's gained a constitution, regulating admission more strictly, and in 1871 the market was incorporated by an Act of Parliament. In 1887 Lloyd's issued its

first non-marine policy, and 17 years later in 1904 its first motor policy, followed in 1911 by its first aviation policy. In 1958 Lloyd's moved to Lime Street.

Between the 1970s and the early 1990s, Lloyd's experienced a boom-to-bust period. Names flocked to join Lloyd's in the 1980s. Some saw Lloyd's membership as being part of an exclusive club. They underwrote business that in many cases was to ruin them.

The most dangerous of the risks was asbestos liability, which had been written on a long-tail basis, meaning that the policy allowed claims to be made many years later. US employees were made ill by asbestosis and sued their former employers, which claimed on insurance and were awarded huge damages in the courts. Lloyd's had to pay out much of the costs, and the Names on syndicates were required to pay.

Catastrophe claims were also significant. In 1988 the Piper Alpha oil platform caught fire and fell into the North Sea. In 1989, Hurricane Hugo struck Puerto Rico, St Croix, South Carolina and North Carolina, and in the same year the oil tanker *Exxon Valdez* ran aground off the Alaskan coast. In 1990 there were severe storms across Europe. There had been a great deal of cavalier underwriting in this area, based on a strategy of offloading the risk.

London Market Excess of Loss (LMX) was used to reinsure catastrophe risks, and it led to what became known as the LMX spiral (for more about excess of loss reinsurance, see Chapter 30). Syndicates and insurance companies would pay the first slice of a loss, and would pass the next slice onto a reinsurer. A third slice would be passed to another reinsurer, and the spiral would continue through the market, sometimes winding back to the original insurer or reinsurer, which might take another slice, effectively reinsuring itself.

From 1988–92 losses at Lloyd's were £8 billion and the market's survival came into question. In 1991 several thousand Names resigned from Lloyd's, and others reduced or stopped their underwriting commitments. Many refused to pay cash calls. Some took legal action against members' and managing agents for negligent advice, negligent underwriting or closure of years of account, and against auditors. Some loss-making Names alleged that certain members' agents had known of pending legal actions affecting the syndicates that they advised them to join, but this was never proven.

David Coleridge, then chairman of Lloyd's, appointed a task force under David Rowland, chief executive of broker Sedgwick, which in January 1992 recommended many changes to Lloyd's, including new governance arrangements. One change that arose was that Names could pool their limits into members' agent pooling arrangements (MAPAs), which spread their resources across many syndicates and reduced their risk. Corporate members were introduced. They would have limited liability, but higher deposit requirements to support underwriting activity.

To help Names pay their debts, Rowland created a hardship committee. It was headed by Lloyd's council member Dr Mary Archer, wife of best-selling novelist Jeffrey. Names who proved they were in financial hardship could pay up in stages or on a deferred basis.

In 1993 David Rowland became Lloyd's first full-time paid chairman. In 1996 he completed a market-wide Reconstruction and Renewal settlement plan. The main part was to form Equitas Reinsurance Ltd, which would reinsure past liabilities, so bringing 'affordable finality' to Names.

Lloyd's made Names a £3.2 billion settlement offer. This partly consisted of £1.1 billion of litigation settlement funds mainly from errors and omissions insurers, who insured underwriting (managing and members') agents and auditors against liability for their professional negligence to the Names for whom they acted. The rest was in the form of £2.1 billion of debt credits consisting of contributions to the settlement by members of Lloyd's, underwriting agents and brokers, and Lloyd's itself. These debt credits reduced the outstanding liabilities and Equitas' premium of Names. To help Names pay their share of the remaining shortfall, special arrangements allowed for an early release of anticipated surpluses from the 1993, 1994 and 1995 years of account.

Lloyd's sent out its settlement offer to all 34,000 Names at the end of July 1996 and by the first closing date, 28 August 1996, acceptances were sufficiently high for the Council of Lloyd's to declare the offer unconditional. Ultimately about 95 per cent of Names accepted the settlement offer. Any who refused the settlement offer did not have access to the debt credits, but in case of a litigation settlement, would have access to a dedicated fund for that purpose.

Equitas performed its promised task of closing all the 1992 and prior years of account of Lloyd's syndicates, writing non-life business by way of reinsurance of those syndicates. It proceeded with the run-off of the business. The level of finality it gave Names included a residual risk should Equitas fail to pay off the liabilities to policyholders in full. Subsequently, in October 2006, Lloyd's reinsurer Equitas announced a deal with National Indemnity Company, a subsidiary of Berkshire Hathaway. In June 2009, a UK court approved a transfer of 1992 and prior non-life insurance liabilities to the new company. Under UK jurisdiction, this meant that Equitas had delivered finality to the Lloyd's Names. If they have to pay out, they will be covered by reinsurance – from Equitas, itself reinsured by National Indemnity Company.

How Lloyd's works

Lloyd's consists of around 80 syndicates, each of which is no more than a collection of individuals and companies that have agreed to join together to

underwrite insurance risks at Lloyd's. A syndicate may trade under the same name and number for years, but it is a series of annual ventures. The members of Lloyd's, who are the insurers, include companies as well as individuals, known as Names. Members may underwrite through just one syndicate or several syndicates.

Lloyd's members have 'several liability', which means they are not responsible for each other's losses, but there is an element of mutualised risk in that the Central Fund is available, at the discretion of the Council of Lloyd's, to meet the underwriting liabilities of any member. All members are required to pay an annual contribution to the Central Fund, which is part of the Lloyd's chain of security, explained later in this chapter.

The syndicates cover specialist classes of business such as marine, aviation, catastrophe, professional indemnity and product liability. Reinsurance makes up more than one-third of Lloyd's income. In the 1980s there were more than 400 syndicates, but by mid-2007 the number was down to 72, and by 2009 it had risen back up to 80. Notable mergers include Catlin Group's agreement in October 2007 to buy its smaller rival Wellington Underwriting for £591 million to create Lloyd's largest underwriter.

Members of Lloyd's remain liable for the insurance business they underwrite until the exhaustion of all liabilities. The practice at Lloyd's is to close syndicate years of account after a suitable period, however, by reinsuring the syndicate into a subsequent year of account of the same syndicate or into another Lloyd's syndicate. Typically, syndicates are reinsured to close after they have been open for three years, but where the liabilities of the syndicate are particularly uncertain, the syndicate's open period may be longer.

Given this process, a syndicate will often have liabilities not only from policies written in the year it has accepted business, but also from policies acquired in reinsuring to close the previous year of account. Participants on the same syndicate in the next year may be different, or in some cases the same, but with different participations, which means they may be effectively reinsuring themselves in respect of prior year liabilities. Members have the right to participate in syndicates for the following year, but if they choose not to, they may be able to sell their capacity in an auction process which Lloyd's runs each year, allowing members to trade syndicate capacity.

The syndicates compete for business, and cover all or part of the risk, depending on their capacity, their specialisations and their view of the risk. Specialist managing agents underwrite the business on behalf of the syndicates, and the managing agents are staffed by underwriters, on whose judgment the market depends.

The subscription market

The subscription market is where various underwriters, both at Lloyd's and in the insurance company market, underwrite a single risk. They subscribe to percentage lines of the risk on a several, not joint, basis. Typically, one of the underwriters acts as leader in agreeing the terms of cover and the policy wording, and in making decisions on claims.

There are three levels of subscription. In traditional subscription, a model that still prevails, lead underwriters make the decisions about the terms on which they will accept the business, if at all, setting the premium payable to the syndicate for underwriting the risk. Other underwriters follow suit, taking a slice of the risk, as presented by the broker, who will then move on to the next syndicate.

A second level of syndication is the split rating method, where markets are encouraged to do their own pricing, and do not know the price the leader set. A third alternative is verticalisation, where underwriters provide the terms on which they write lines. This arises in the aviation market, with the lead market setting a different price from the following market, causing some confusion and problems with claims.

The managing agent employs underwriting staff and manages one or more syndicates on members' behalf. There are 51 managing agents, most of which are now owned by listed companies or backed by insurance-related capital. The only function allowed to a managing agent is syndicate management. Each managing agent employs underwriting staff, provides computer systems, and decides on the syndicate's underwriting policy in conjunction with the underwriters.

The members' agent manages the affairs of Names, advising them on which syndicates they should participate. In 2009, there were only three members' agents at Lloyd's.

The Corporation of Lloyd's runs the market, and has the power to stop any syndicate from underwriting or to remove the right of any managing agent to trade at Lloyd's. In general, Lloyd's plays a significant role in supervising the market, although the Financial Services Authority (FSA) has overall regulatory responsibility.

Capital backing

Initially, only individuals underwrote at Lloyd's. In 1994 companies were allowed to underwrite at Lloyd's for the first time. Between 1997 and 2009,

private capital fell from 50 to 15 per cent of market capacity, of which 6 per cent is provided by limited-liability backers. There are 773 Names with unlimited liability, down from 32,000 in 1988, and Lloyd's is taking in no new applications. Overall, the corporate members do 85 per cent of the underwriting.

Let us take a closer look at the limited-liability vehicles through which individuals can underwrite at Lloyd's: Namecos, Scottish Limited Partnerships or Limited Liability Partnerships. Members' agents advise the Namecos, which are bespoke registered companies set up for Lloyd's Names and other individuals, and which underwrite on a range of syndicates to spread risk. Corporate capital, in contrast, typically invests in syndicates aligned to the corporate group. Scottish Limited Partnerships and Limited Liability Partnerships each have their own legal status, but operate similarly.

Another option for Names is to underwrite at Lloyd's through Members' Agent Pooling Arrangements (MAPA), which have participations across a spread of syndicates. At the other end of the spectrum are the integrated Lloyd's vehicles, where the sole corporate member of the syndicate is within the same corporate group as the managing agent of that syndicate. The parent company of the group is often listed on a recognised stock exchange.

The special purpose syndicate is a relatively recent development which enables unaligned capital to participate on aligned syndicates by providing quota share reinsurance through a syndicate set up for the purpose (a proportional treaty where the same proportion is ceded on all cessions: see also Chapter 30).

Syndicate capacity

Each year every syndicate is required to have its business plan approved for the following year of account, and the business plan will include a headline 'Syndicate Gross Premium', which is the maximum amount of premium that Lloyd's expects the syndicate to write, net of acquisition cost. This is also a key factor in determining how much capital the syndicate needs in order to support its Lloyd's underwriting. Syndicates have a capacity figure as well, a notional upper limit of premium the syndicate could write, but this is not as significant as the syndicate gross premium for the purpose. In 2008, Lloyd's had £16.1 billion in overall capacity provision, up from £8.9 billion in 1993. The average syndicate gross premium approved for a syndicate in 2007 was £198.8 million.

Regulation

Historically, Lloyd's was a self-regulating body. Lloyd's is now regulated by the FSA, but under the Lloyd's Act 1982 it remains responsible for the management and supervision of the Lloyd's market. Managing agents at

Lloyd's are regulated by the FSA, although the underwriting members operating under Lloyd's supervision are excluded from much of that regulatory framework. The FSA, however, retains certain powers to take over the regulation of underwriting members.

As a result of reforms amending the Lloyd's Act 1982, approved by Parliament in November 2008, there is no longer a ban on Lloyd's managing agents and brokers owning stakes in each other. The Lloyd's Act had prohibited this to prevent problems of conflicts of interest, as in brokers giving business to a managing agent because of a business connection when it was not in the policyholder's best interest. The requirements regarding the management of conflicts of interest are now a matter of FSA regulation, and therefore there was no longer a need for specific provisions to be included in the Lloyd's Act.

Also as a result of the reforms, managing agents may now deal with any regulated intermediary and indeed with policyholders direct, not just, as before, with Lloyd's brokers. The changes in 2008 also had the effect of modernising some of Lloyd's governance provisions. The reforms, welcomed by Lloyd's, were part of the government's overall approach to maintaining the City's competitiveness.

Financial strength

Lloyd's boasts that, even through its troubled times, it has retained its track record of paying valid claims, which now dates back over 300 years. Let us look at Lloyd's financial strength.

Chain of security

Lloyd's chain of security has three links: premium trust funds, members' funds at Lloyd's and central assets at Lloyd's. The earlier the link, the sooner is the financial claim on it. Let us look at how they work.

First link: premium trust funds

The first link consists of insurance premiums received by a syndicate for a given year of underwriting and held in premium trust funds, which are liquid and available to pay policyholder claims made against the members of the syndicates, as well as permitted expenses and outgoings such as reinsurance premiums and underwriting expenses. Only if there were surpluses in the premium trust funds when the syndicate year of account is closed could the money be paid for these purposes. On 31 December 2008, the premium trust fund held £38.3 billion, mostly invested in bonds.

Second link: Members' funds

The second link, known as members' funds, is capital provided by each member at individual syndicate level to support its underwriting at Lloyd's.

The link between the premium trust funds (above) and members' funds is best shown by a simplified example. If a syndicate receives £100 in premium, it will put this amount in the premium trust fund it administers for the members of the syndicate, and will then calculate what its claims will be, based on actuarial estimates. If it concludes that they will be £90, it will keep this amount in the premium trust fund and transfer the remaining £10 to the members' funds where it is available to meet the liabilities of the member on any other syndicate where the member participates, in the event of a shortfall. On 31 December 2008, members' funds were £10.6 billion.

Members' funds are intended to satisfy the Individual Capital Assessment (ICA) that the FSA requires each syndicate to provide in order to cover underlying business risks, with a worst outcome of a 1 in 200 risk covered, so satisfying a 99.5 per cent confidence level. When each syndicate's ICA is agreed with the Corporation of Lloyd's, it is uplifted (by 35 per cent in 2008) to ensure extra capital is in place to support Lloyd's ratings with insurance rating agencies. For more on the ICA, see Chapter 28.

Third link: central assets

In both the first and second link in the Lloyd's chain of security, as described above, members have put up their capital on a 'several' basis. For example, the corporate member of Brit Syndicate 2987 puts up capital for its underwriting liabilities and so does the corporate member of Amlin Syndicate 2001, but Brit money cannot be used to pay Amlin claims, and the reverse is also true. However, central assets, the third link, are held mutually and can be used to pay any member's unpaid losses at the Council of Lloyd's discretion.

If, hypothetically, there were 11 members to a syndicate and each put up £1 billion, and the central assets already comprised £2 billion, then there would be £3 billion (£1 billion plus £2 billion) available to pay any single member's claims, if necessary.

Each year Lloyd's collects 0.5 per cent of premiums from each syndicate for the Central Fund, which in 2008 added up to £84 million. Over the years, these collections have been the main way in which Lloyd's has built up the Central Fund.

In 2002 and 2003 there was a premium levy on members, another way of building up the central assets. Lloyd's introduced the levy after the Reconstruction and Renewal plan to repay a £285 million loan, and continued it,

increasing the rate from 1.1 per cent to 2 per cent, in the knowledge that extra claims were pending as a result of the 11 September 2001 attacks on the United States. It has not been levied since.

Other parts of the central assets are the corporation assets, which include, but are not confined to, cash and investments; and subordinated debt, consisting of £500 million that Lloyd's borrowed in 2004 in the capital markets, and a further £500 million in June 2007. It will have to repay this debt, as well as pay interest on it.

The callable layer is an option to move up to 3 per cent of capacity from each business's premium trust fund into the central assets.

In aggregate, the value of Lloyd's central assets, excluding the callable layer and the liability in respect of subordinated debt and securities, amounted to £2,072 million in December 2008. These comprised the Central Fund at £852 million, corporation assets at £138 million, and subordinated debt at £1,082 million. The callable layer consisted of a maximum £495 million.

Solvency ratio

The solvency ratio may be defined as central assets in relation to outstanding claims in relation to insolvent members (solvency deficiencies). A member is insolvent when it does not have enough assets to meet its underwriting liabilities and solvency margin. In the insurance companies market, the FSA's focus on a company is increased if its solvency ratio falls below 200 per cent.

If Lloyd's solvency ratio were to fall below 100 per cent it would fail the regulatory solvency test. At the end of 2008 it was 1,958 per cent, up from 812 per cent at 2006, based on assets of £2,608 million, in relation to solvency deficiencies of £134 million. Lloyd's solvency position is calculated regularly.

The Franchise Board

The Lloyd's Franchise Performance Directorate (FPD) was implemented in 2003 because of some poor past underwriting. The performance framework is prudential in nature.

The Corporation reviews the business plans of syndicates through the FPD, which can reject a managing agent's plan or require changes to it. All managing agents must submit quarterly monitoring reports to the directorate.

The FPD also does risk management, undertaking a disaster planning process to identify and monitor key aggregation and catastrophe exposures. Since the late 1990s, Lloyd's has run a Realistic Disaster Scenario (RDS) framework which assesses syndicate and market exposures to a range of potential natural and human-made events, including hurricanes in the United

States, typhoons in Japan and two planes colliding above a major city. Lloyd's expects that, where catastrophe models are used, there should be more than one, and skilled and experienced staff should do the modelling.

If a syndicate's underwriting or operational performance poses an unacceptable risk, the board can take action, and at the extreme, terminate the right of a managing agent and its syndicate to trade in the market.

One-year accounting

On 1 January 2005 Lloyd's financial reporting regime moved from three-year fund accounting to annual accounting under UK Generally Accepted Accounting Principles (GAAP), which facilitated comparison with insurance company results using, for instance, the combined ratio (losses and expenses as a percentage of premium earned).

The accounting difference can be considerable. Under annual accounting, the Lloyd's loss from the 11 September 2001 terrorist attacks on the United States was accounted for in the 2001 financial year, when the loss occurred, but under three-year accounting, it was split between 1999 (a very small proportion), 2000 and 2001, the years in which the relevant insurance policies inceptioned.

The 12 months of underwriting that make up an underwriting year are held open for three years as claims can come in over this full period, following which the risk is passed on through the reinsurance-to-close process, covered in the next chapter. The three-year account is still maintained in order to keep equity between members and for distribution purposes. Each member takes its share of the syndicate's profit or loss for a particular year of account, based on the proportion in which it agreed to participate before the start of the year of account.

International progress

Lloyd's has licences in over 70 countries, and a representative office in India. Lloyd's underwriters accept risks from over 200 territories and countries. This has not always been easy because of how others react to the unique Lloyd's structure. Lloyd's does the highest proportion of its business in the United States and Canada, accounting for 44 per cent in 2008, compared with 22 per cent in the United Kingdom and 16 per cent elsewhere in Europe, 8 per cent in Central Asia and Asia Pacific, 6 per cent in other Americas, and 4 per cent in the rest of the world.

In 2009, as the third edition of this book was in preparation, Lloyd's was applying for a licence in Portugal and exploring options for obtaining new

trading licences in South Korea, Vietnam, Turkey, Russia, Hungary and Romania. Lloyd's is the first international player to have received regulatory approval to be admitted as a reinsurer in Brazil, a country where abundant infrastructure projects are planned for the next few years.

Meanwhile, there is interest from Bermuda, Japan, the United States and continental Europe in establishing a presence at Lloyd's, whether as a start-up or an acquisition. The UK government has recently agreed to bring the tax treatment of Lloyd's members' technical reserves in line with that of general insurers, which will help Lloyd's to continue to compete globally.

Lloyd's, like London company insurers, is making more use of managing general agents (MGAs) around the world. About 30 per cent of the dollar premium going into Lloyd's from the United States is now processed through MGAs, known at Lloyd's as 'coverholders'. The Lloyd's syndicate provides the capacity and the MGA writes insurance policies on the syndicate's behalf.

Lloyd's is licensed for writing only surplus lines business in its largest single market, the United States, except in two states. The surplus lines market allows US companies to find cover for complicated or hard-to-place risks not available in the standard market. After AIG's bailout by the US government, buyers are inclined to diversify their insurance coverage, which makes Lloyd's attractive, given that, as a subscription market, it can provide capital from more than one syndicate.

The future

Lloyd's expense levels in relation to net premiums look relatively high, according to credit analysts. The expenses are partly due to the type of business Lloyd's writes, which involves a long distribution chain, compared with, for instance, the more direct business-writing model in Bermuda. To address the expenses issue, Lloyd's is focusing on efficient processing as a top priority.

Lloyd's is benefiting from improved risk management at syndicate level and underwriting controls imposed by the FPD. This has not yet been tested in a downturn although, according to credit analysts, Lloyd's FPD is likely to curtail the extent of losses seen in previous downturns.

Structurally, Lloyd's unique diversity of capital is under threat given the shift from individuals underwriting with unlimited liability. But this shift helps to protect Lloyd's from reputation risks arising when Names cannot or will not pay liabilities, and undertake high-profile court action or settlement negotiations. Lloyd's has said that if its position is to be maintained, new ways must be found for unaligned capital providers to access syndicates in a way that is attractive to both managing agents and the capital providers.

In July 2009 Lloyd's embarked on its largest strategic review of the decade to make sure that the market took advantage of opportunities that had arisen in the financial crisis. The review was to examine Lloyd's product mix, distribution and geographic balance. Lloyd's was helped by consultants from Deloitte, and intended the review to feed into a new strategic plan to be published in January 2010.

Reinsurance

Introduction

In this chapter we shall examine the process of reinsurance, which is essential to the insurance industry as a way to spread risk further. We look at contractual issues and retrocession. We explore financial reinsurance and insurance securitisations, then move on to international regulatory issues, including the Reinsurance Directive and developments around the reduction of US reinsurance collateral requirements for alien reinsurers. We shall look finally at dispute resolution, including arbitration, litigation and mediation.

Overview

Reinsurance is a product for insurance industry professionals. It enables them to transfer their own risks to a reinsurance company, but it does not change the total risk exposure to the potential adverse event.

The process works as follows. The insurer wants cover for the risk it has taken onto its books, so seeks to reinsure it by passing on the liability to a reinsurance company. As the ceding office, it pays a premium to the reinsurer, which accepts the cession and assumes responsibility for claims. Any of the business that the insurer keeps, rather than passing onto the reinsurer, is known as retention.

In this way, reinsurance helps insurance in its main aim, which is to spread risk. Reinsurance enables insurers to limit loss exposure and so to offer higher coverage limits or to cover a greater number of risks. It increases the capacity of insurers to take on more business than it is safe for them to write unaided, and helps them to stabilise earnings when major events arise. The reinsurer also provides support services, such as technical training and accounting.

A reinsurance placement is typically shared among more than one reinsurer. A 'lead' reinsurer sets the terms and 'following' reinsurers subscribe to the agreed contract. Reinsurance can be written through brokers, who can represent a number of participating reinsurers, each assuming part of the risk, or it can be written directly from ceding companies. In reinsurance, loss data is often less available than in insurance, which makes the underwriter's job in this area more critical.

Reinsurance is an international business and through reinsurance contracts, the London market links with the United States, Bermuda, continental Europe and elsewhere. Reinsurance may be divided into proportional and non-proportional reinsurance. Let us look at each.

Proportional reinsurance

In proportional reinsurance, the reinsurer takes a percentage share of the policy, receiving a fixed percentage of premium income from the original policyholder and paying the same percentage of claims payments. Under this arrangement, if the reinsurer receives 40 per cent of the premiums, it will pay 40 per cent of the losses.

The reinsurer also pays a ceding commission to the insurer to cover the costs of writing business and administration, which may include a profit element for providing the business.

One form of proportional reinsurance is quota share business, where premiums and losses are shared pro rata. Another form is surplus treaty, where the ceding company retains a defined amount as a line, keeping all the premiums and losses, beyond which there is a proportional split.

Property insurers prefer proportional reinsurance because the sum insured is usually known, making proportional divisions practical.

Non-proportional reinsurance

Non-proportional reinsurance is where the reinsurer pays out only if the loss is beyond the insurer's retention, meaning the amount of the loss it will accept. It is commonly handled as excess-of-loss reinsurance, where the ceding office pays the initial layer of every valid claim. The reinsurers pay the balance of losses up to a set figure, and this is known as 'working layer' or 'lower layer' excess-of-loss reinsurance, beyond which further excess-of-loss cover may apply.

Losses in the lower layer are more predictable than in the higher layers because of greater historical frequency.

Reinsurance contracts

The two basic types of contract are treaty and facultative. Both may be written on a proportional or non-proportional basis, or as a mixture of both.

Treaty reinsurance

Treaty reinsurance is an agreement covering a class or classes of business, and it automatically covers risks written by the insured without evaluation of individual exposures.

The treaty reinsurer will review the ceding company's underwriting practices, risk management and claims settlement processes, and its evaluation will affect the pricing of the treaty. The reinsurer is ultimately dependent on the underwriting decisions of the primary policymaker.

Reinsurance treaties can be written on a term basis, with an expiry date, or be continuous, but with a notice period built in. The most usual buyer is a senior insurance company executive.

Facultative reinsurance

Facultative reinsurance provides an insurer with coverage for specific risks, typically large or unusual, that are not covered in its general reinsurance treaties. Each facultative reinsurance contract is agreed individually, which requires significant resources to implement, but enables the underwriter to price the contract more accurately. Unlike in treaty reinsurance, the most usual buyer is the insurance underwriter who underwrote the original policy.

Doctrines

To understand the relationship between the reinsurer and the reinsured, let us focus on two doctrines: utmost good faith and follow the fortunes.

Utmost good faith

Parties to a reinsurance contract should be honest with each other. The reinsured should disclose all material facts and should enter appropriately into any settlement with the original policyholder.

The reinsured should give adequate notice of any claim to the reinsurer, giving it time if it should wish to participate in defending the claim, as well as to find funds.

Follow the fortunes

The reinsurer must follow, and act in accordance with, payments to the original policyholder by the reinsured, so following its fortunes. The doctrine is not infallible, however, as court findings have shown.

Retrocession

Retrocession is where a reinsurer reinsures its own business. This is done under a retrocession agreement with another reinsurer, the retrocessionaire, to cover risk exposure or obtain extra underwriting capacity.

The reinsurance of reinsurance process may continue until the original receiver receives back some of its own business, which is known as a spiral, as in the LMX spiral (see Chapter 29). In the past, retrocessionaires involved in spirals have sometimes refused to pay.

Specialist forms of reinsurance

Financial reinsurance

Financial reinsurance, which started life in the United States, has since given rise to some controversy. Financial reinsurance can take various forms, but it is invariably arranged for financial or strategic reasons with little or no risk transfer from the insurer to the reinsurer. Unlike in traditional reinsurance, the level of claims makes no difference to the premium the insurer pays and the profit the reinsurer makes.

One use of financial reinsurance is to smooth the insurer's profits. In this case, the insurer transfers money to the reinsurer in good years that can be used to offset losses in bad years. The product may also be used to provide increased reinsurance protection as a way to strengthen the balance sheet, giving the impression that the company is stronger than it really is.

According to the Financial Services Authority (FSA), financial reinsurance should be disclosed and accounted for properly, failing which it can be construed as concealing the financial position of a company. If reinsurance genuinely transfers risk, it should be risk-accounted and recognised as such in the company's accounts, but a contract that does not meet the risk-transfer criteria should be deposit-accounted, and treated as a loan in the balance sheet.

In several cases, the FSA has demonstrated that it understands the concept of financial reinsurance, and has the appetite to penalise its misuse.

Capital markets convergence

To meet demands for capacity, traditional reinsurance has converged with the wider capital markets, which Lloyd's chairman Lord Levene has described as bringing 'new creativity' to the market.

After the 2004 and 2005 hurricane seasons and scares such as bird flu, some shortage of retrocession capacity in catastrophe cover arose. Cat (catastrophe) bonds, the oldest of the structured insurance products, as well as newer structured insurance products, such as sidecars, flourished as a means of transferring risk. Another use of structured insurance products is to achieve capital relief in line with regulatory requirements. Solvency II, the EU Directive planned for implementation in 2012 (see Chapter 28), is encouraging this. Let us now take a look at the main individual products.

Cat bonds have existed since 1997 as a form of reinsurance cover sold as debt. Insurance risk is converted into a bond, which a special purpose reinsurance company, established in an offshore location, sells to investors. The bond sale proceeds are placed in a collateral trust, are invested in highly liquid paper, and are used to pay losses by the reinsured.

The cat bond is an excess-of-loss arrangement, and investors will lose money only if the excess is triggered. The detachment point can vary. In the late 1990s, overcapitalised reinsurance companies assumed catastrophe risk more cheaply than investors in cat bonds, which slowed the product's development.

The sidecar is an alternative to a cat bond. It is riskier because it takes on a proportion of the reinsurer's risk, but to reflect this, pays investors a higher return. The sidecar is a form of captive, which is, broadly speaking, an insurer owned by the reinsurance company for which it provides cover. The sidecar is registered typically in Bermuda, or less often in the Cayman Islands.

The sidecar provides catastrophe coverage to its sponsor reinsurance company for a period of perhaps two years. In this way, it takes risk off the parent's book, so enabling it to write more business. It is designed to capitalise on potentially temporary market conditions, and it can be dismantled quickly.

Short-term securities are issued to institutional investors to fund the sidecar. The premiums from the reinsureds and equity capital from investors are typically paid into a trust account, which can collateralise each policy written by the sidecar on a probable maximum loss basis or up to the policy limits.

Another form of insurance securitisation is embedded value securitisation, which is the monetisation of the future profits of a portfolio of life insurance contracts. Monetisation aims to decrease the capital that life insurance companies must hold. The procedure is to get cash upfront from investors, repaying them by the profits generated from life insurance contracts.

The money invested in structured products is still small compared with conventional reinsurance, and much of it is from hedge funds and private equity, particularly in the United States where there is greater willingness to take a risk for high returns.

For investors, what matters most is the return. In 2006, the average sidecar had better returns than most stocks, although by mid-2007 stocks were showing much better returns than the previous year. The risk of investing is priced into the sidecar. Investors may have a problem getting money out of the sidecar after a loss event, given that reinsured parties, otherwise known as cedants, may hold money back to cover unknown losses.

When implementing the Reinsurance Directive, the FSA exercised its option to allow credit for reinsurance transactions, using insurance special purpose vehicles.

Reinsurance reassessed

In recent years, insurers have become less inclined to use reinsurance as a substitute for their own good underwriting. They are giving brokers less discretion in choice of reinsurer, particularly for long-tail business, where the liability may be discovered and claims made many years after the loss was caused. Some £200–£300 million insurance payouts to parties who claimed on long-tail asbestos-related diseases had served as a warning.

There is an increasing use of downgrade clauses by which, if a reinsurer's rating falls below a trigger level, the primary insurer may be permitted to void the contract or require collateral to be posted.

International regulatory developments

The Reinsurance Directive

The Reinsurance Directive is a component of the European Commission's Financial Services Action Plan and was implemented in the United Kingdom in December 2007. This is an interim solution for reinsurers, pending implementation of the broader Solvency II Directive in 2012. It aims to create a single regulated market for pure reinsurance business, creating a level playing field across the European Union. For many member states, it introduces regulation of the reinsurance industry for the first time.

Reinsurers have tended to do business through subsidiaries across Europe with separate solvency and reporting requirements, but the Directive enables

them to write business through a single entity across the European Union, based on one licence and supervised by a home regulator. On this basis, reinsurers will be able to hold their capital in a single entity, manage it more efficiently and save on costs. Life and non-life reinsurance may be written from the same entity.

The Directive encourages consolidation and provides an incentive for reinsurance groups to select a home state in the most favourable regulatory and tax environment. In March 2007, Zurich-based Swiss Re, the world's largest reinsurer, said that it would optimise its legal entity structure in the European Union by forming three legal entities, based in Luxembourg, which will serve as risk carriers for most of its European reinsurance and insurance business, operating via branches in the rest of the European Union. Swiss Re aimed to have the new structure in place by mid-2009.

In London, the Reinsurance Directive has brought about a significant increase in compliance and reporting obligations. The Directive eliminates reinsurance-related collateral requirements across Europe. This is helping to encourage the United States in the same direction.

US reinsurance collateral

The National Association of Insurance Commissioners (NAIC) Reinsurance Regulatory Modernization Framework is part of the biggest story in reinsurance regulation, and could change dramatically how reinsurance is regulated in the United States, which is of great significance for London. Lloyd's does 44 per cent of its business in the United States.

The United States is the largest insurance and reinsurance market in the world, and it has 50 states with their own rules. The country has a 'credit for reinsurance' approach by which collateral is required from reinsurers only when a ceding company wants to have credit for reinsurance. If a reinsurer is not licensed in the United States, the ceding company cannot take credit for reinsurance unless it posts collateral. Despite this strict approach, the United States has probably had more reinsurance problems than any other country, including reinsurance frauds in the 1980s, insolvencies in the 1990s and finite reinsurance in the 2000s.

European reinsurers have been lobbying to change the reinsurance collateral rules in the United States for a very long time. Europe jumped ahead by conceiving and adopting the Reinsurance Directive (see above). In December 2008 in the United States, however, the Executive/Plenary session of the National Association of Insurance Commissioners' winter meeting voted overwhelmingly to adopt the NAIC Reinsurance Regulatory Modernization Framework.

The framework has some burdens and benefits, and it is optional. Some companies are not in favour of it and may stay in the current system. The

framework is to be enacted by federal enabling legislation, and is initially for non-life reinsurers only.

The framework will set up a new entity, the Reinsurance Supervision Review Dept (RSRD), which will sit as a regulatory body within the auspices of the NAIC, and have the sole task of vetting insurance regulators, US and non-US, and seeing whether they are up to standard. There are ongoing discussions about who controls the RSRD and how it operates.

Under the framework, non-US reinsurers pick one US state to be a port-of-entry state, but they can only do this if their domestic regulator is approved by the RSRD. US reinsurers must be domiciled in an approved jurisdiction.

The system has benefits for US reinsurers in giving them a one-state regulatory system for their transactions, which is what they had wanted. For this reason, the Reinsurance Association of America supports the framework.

Under the current rules, a licensed reinsurer posts no collateral and an unlicensed reinsurer must post 100 per cent, whether it is AAA- or C-rated by the credit rating agencies. Under the new framework, there would now be a credit assessment, applying collateral on a reduced basis, broadly for US as well as non-US reinsurers. This is a compromise with the ideal for which the London market, as well as many continental European reinsurers had campaigned, which was for zero collateral to be posted by all highly rated, highly regulated reinsurers.

Under the new framework, there is no collateral for catastrophe losses for one year for adequately rated reinsurers. After the 9/11 events, regulators came to realise that if reinsurers have to post 100 per cent collateral, they would face cash flow rather than solvency issues, as a lot of catastrophe losses were paid quickly.

The new rules are prospective only, but if a reinsurer's rating declines by even one level, it must increase collateral coverage for all liabilities. If the rating rises, the reinsurer only obtains any reduction in collateral requirements for liabilities arising after the upgrade. If a reinsurer uses solvent schemes of arrangement for any part of its business that affects US ceding companies, 100 per cent collateral is required.

The framework requires federal law to implement it, and delegate regulation back to the RSRD. State regulators acknowledged that if they tried to implement the framework by way of a new NAIC model law, it would take many years to get adopted in all states, but if it got through Congress, it would be the law in every state.

At the time of writing this book's third edition, the next steps are to draft federal enabling regulation and then to fight this out in Congress. Some segments of the domestic reinsurance industry strongly oppose the reforms. This could lead to delays, and the global financial crisis has not helped progress.

Individual state action, meanwhile, is underway. New York is developing its own new collateral rules, based on NAIC proposals, but which apply only to non-US reinsurers. Florida has adopted its new reinsurance rules, and Texas is thinking about its own.

Dispute resolution

When disputes arise between insurers and their reinsurers, the most usual way to resolve them is through arbitration. The arbitration process is acknowledged as slow, expensive, adversarial and risky, and although every case is supposed to be confidential, parties involved sometimes leak details. Guidelines from the Chartered Institute of Arbitrators restrict parties to arbitration from liaising inappropriately with prospective arbitrators before deciding whether to appoint them.

Litigation applies in only a small percentage of cases, but it is seen as more efficient than arbitration. The court system is streamlined, and both barristers and judges are reinsurance savvy.

There is a growing interest in mediation as an alternative to arbitration. The process tries to preserve relationships, which are an important part of the London market. Mediation resolves some disputes, offering genuine confidentiality. There is no obligation to settle, and even if the mediation fails to produce a complete solution in the allotted time period, it might still provide insights to the parties.

Retail insurance, savings and domestic property

Introduction

In this chapter, we shall look at retail mortgage, insurance and savings products. The link with the City is that sometimes these products are sold within the Square Mile, and the premiums and deposits arising are invested by asset managers who may be based there. We focus on some regulatory developments, and on complaints and compensation procedures. Read this in conjunction with Chapter 32, which covers pensions and annuities.

The regulator's view

In March 2006, the Financial Services Authority (FSA) published a survey in which it found that many people were failing to plan ahead adequately for retirement or for an unexpected major expense or drop in income.

Since then, the climate has changed. In an address to the 2009 conference of the Association of British Insurers (ABI), Adair Turner, chairman of the FSA, noted that, on the savings side, the economic context ought to create an opportunity for insurers because the savings rate was increasing. This came after a period in which personal savings had been heavily focused on the accumulation of housing equity, with the relative importance of financial asset accumulation declining. So far, most of the new savings, Turner acknowledged, had gone into bank deposits or into paying down mortgage debt, rather than into life insurers' longer-term savings products.

Let us take a look at some of the products competing for a share of consumers' savings.

Products

Property and mortgages

The biggest personal investment most people make is their home. There is now no tax relief on mortgages for the purchase of a home. Stamp duty is payable on properties priced above £125,000, on a rising scale according to the cost of the property.

If you use your property as security on a purchase loan, you will take out a mortgage. This is the most usual way to acquire your home. According to the Council of Mortgage Lenders (CML), there are 1 million mortgages held in the United Kingdom, with loans worth over £1.1 trillion.

A mortgage may be repayment, interest only, or a combination. The repayment mortgage requires the borrower to pay the lender a monthly sum that combines repayment of capital borrowed with interest on the loan. If the borrower makes all the payments, the loan will have been repaid at the end of the mortgage term.

With an interest-only loan, the borrower pays only interest to the lender every month, and at the end of the term they pay back the original debt in a lump sum. They need a savings vehicle, perhaps a pension or an ISA, to build up enough money over the years to pay it off, although they can also pay sums throughout the life of the loan.

In the past, endowments were taken out for this purpose. Unfortunately, many endowments were mis-sold in the late 1980s and early 1990s on the basis that they would pay off mortgages. Declining stock markets and overall returns meant that at the repayment date there was often a shortfall. Companies have been paying some compensation and there is no longer any real market for new endowments.

Some mortgage providers offer lower rates for a certain period, which provides reassurance for those concerned about interest rate volatility. This may be provided through a fixed-rate mortgage, which guarantees the level of monthly payments.

Other forms of lower-rate mortgage offers include a discount mortgage, where the rate is set at a margin lower than the lender's standard variable rate for an initial specified period, and a capped rate mortgage, which sets an upper limit. For a tracker mortgage the interest is set at a margin above or below the Bank of England's base rate.

In an offset mortgage the credit the borrower holds with the lender is offset against what they owe on the mortgage. The main advantage is that it is tax-efficient because savings can be used to pay off parts of the mortgage

rather than earning interest at a taxed rate. Another advantage is flexibility, meaning that the borrower can make repayments when they have the cash to do so, but withdraw from the mortgage account when they need cash for something else. Among more seasoned property buyers, 'buy to let' is popular when times are good.

If the borrower is unable to make the agreed repayments on a mortgage, the lender can sell the property to recoup the debt.

In mid-2007, the FSA raised concerns about the UK sub-prime mortgage market, which provides home loans to consumers with less than pristine credit records, and on industry estimates, accounts for about 5–6 per cent of total industry gross advances. The equivalent US market had already suffered defaults that cast a ripple around world markets (see Chapter 12).

At this point the FSA started enforcement action against five unnamed firms, known to be intermediaries, after it found weaknesses in responsible lending practices and in the firms' assessments of consumers' ability to afford a mortgage.

The number of loans with arrears of more than 2.5 per cent of the mortgage balance reached 205,300 in the first quarter of 2009, up 62 per cent on the 127,000 a year earlier.

Life policies

The two key non-investment life products available are whole-of-life and term insurance.

Whole-of-life policies pay out when the insured person dies. They pay regular premiums to build up a pot of money, which is invested, and the cover is not limited to a set period. Gains on a qualifying policy are free of any further tax charge. The product is useful for inheritance tax purposes. If someone has children who will be beneficiaries of their estate, but is subject to an inheritance tax liability, they can take out a whole-of-life policy and write it in trust for their children, with the result that it will provide a lump sum to pay on that liability. This is an area where specialist advice is needed.

Term insurance is cheaper than a whole-of-life product. It pays out a tax-free lump sum, or a family income benefit, only if the insured dies within a specified period. If they do not die before the end of the period, the cover ends and there is no payout. Many people take out term insurance in conjunction with a mortgage.

Pension term insurance (PTA) gave policyholders tax relief on premiums paid at their marginal rate, as for a pension product. The product was scrapped by the government only eight months after it was introduced in April 2006.

Protection products

The key protection products are private medical insurance, income protection insurance, critical illness insurance, long-term care insurance and payment protection insurance. Let us consider each.

Private medical insurance covers the cost of private medical treatment of acute conditions, defined as illness or injury, where treatment will lead to recovery. Premiums increase with age.

Income protection insurance pays a tax-free monthly income for an agreed period if the insured is unfit to work because of sickness or accident, resulting in a loss of earnings.

Critical illness insurance pays a tax-free lump sum if the insured contracts any illness or condition, or has any surgical procedure, that is covered by the policy. The product tends to pay salespeople a higher commission than income protection. There is a high level of rejected claims. As the FSA has found, customers have not realised that prior medical conditions are material and have to be disclosed when the policy is taken out, or there will not be a valid claim.

Long-term care insurance covers the cost of long-term care in an individual's home, or in a residential or nursing home, should it be required. It includes a wide range of care services.

Payment protection insurance (PPI) policies are designed to help people repay borrowings such as mortgages or credit cards should they become unable to work because of an accident, illness or because they unexpectedly lose their job. The FSA has cracked down on poor selling practices and a lack of proper compliance controls among firms promoting PPI. The product is usually sold in conjunction with something such as a car. Exclusions have not always been made clear and consumers typically do not shop around before they buy.

In his June 2009 speech at the ABI biennial conference, Turner noted that mortgage PPI policies had not previously been a major focus of FSA concern, but might become one in an economic downturn.

Investments with life insurance

In this section, we discuss products that are primarily for investment, not protection, but include an element of life insurance. These are either endowments or investment bonds.

For practical purposes, an endowment is a regular savings version of an investment bond, but is more tax efficient (see above, under 'Property and mortgages'). Investment-type insurance is based around endowments.

An investment bond is a savings vehicle. The key benefit is that it enables the holder to defer, or possibly to avoid, any additional higher-rate tax on gains

and income generated by the bond. The product is useful for those who are subject to higher-rate tax, but in the foreseeable future will no longer be in the same tax bracket. Financial advisers can receive a high commission to sell this product, and so have often been known to recommend it above cheaper and more tax-efficient alternatives.

General insurance

Products such as motor and home contents insurance were the least affected by the 2007–10 financial crisis, but they were not immune from it. According to June 2009 ABI figures, 22 per cent of people said that they had not renewed their home contents insurance in 2009 to save money, and 17 per cent had not renewed their building cover.

Various savings products

Banks and building society accounts

In the past, a savings account with a bank or building society was either instant access, which paid a little interest, or a notice account, which paid more. In today's more competitive environment, some accounts have both high rates and a short notice requirement, if any, but there may be catches. The rate might fall away after six months or an even shorter time, or if you make more than a certain number of withdrawals within a set period.

There are jurisdictional risks linked to savings accounts outside the United Kingdom. Under passporting arrangements, banks in countries within the European Economic Area can make bank accounts available to UK savers through the internet. If the bank fails, savers will have access to that country's own compensation scheme, which may not have the standards of the UK scheme. In some cases it might be better, as in the case of the Netherlands scheme. In Iceland it is worse, as became publicised when Icelandic banks offering accounts to UK savers ran into problems in 2008. In Ireland, the government guaranteed all savings in banks until 2010, but the country itself is now perceived as a risk.

ISAs

An Individual Savings Account (ISA) is a wrapper that protects investments held in it from income and capital gains tax. An ISA can be pre-wrapped as a cash account or fund, or it may be freestanding, where you select the investments to hold in it.

Every year the public has invested about £28 billion in ISAs, with increasingly more in cash and less in shares. From 6 April 2008, government reforms

have simplified the ISA regime and made it more flexible for users. The upper limit for a stocks and shares ISA is £7,200, and for a cash ISA is £3,600.

National Savings and Investments

National Savings and Investments, the UK's second largest savings institution, started life in 1861 as the Post Office Savings Bank. It manages around £73 billion in government funding, about 8 per cent of the UK retail savings market. It promotes secure, sometimes tax-free, government-backed savings products, but the returns tend to be uncompetitive. Interest rates may be fixed, variable or index-linked.

Wills

A will is a formal arrangement to distribute your assets after your death. To be valid, it must be in writing, signed by the testator, and witnessed. If you do not make a will, your estate will be distributed under the laws of intestacy.

Should your estate be worth more than £325,000 (tax year 2009–10), it will be subject to rules on inheritance tax.

How the products are sold

If you are willing to buy without advice, you will have access to a wide range of financial services products at a discount from, for example, an internet supermarket or in some cases an online broker. Most of the discounted products are collective investments (see Chapter 19).

The traditional way to buy personal finance products is from a financial adviser, who assesses your needs and recommends what is, or should be, suitable. A series of mis-selling scandals have damaged public trust in advisers.

You can choose between an appointed representative, who works for one financial services company and offers only its products, an independent financial adviser (IFA), who theoretically advises across the marketplace, or a multi-tied agent, often a bank that sells products from a select number of companies.

Some customers use multi-tied agents without fully understanding that they are receiving a more restricted service than provided by an IFA, although it is no cheaper. Some firms are a combination of IFA and multi-tied. Some banks are multi-tied in investment products, but not in insurance products, and they sell their own brand of insurance only, which can be expensive.

The IFA must offer customers a choice of paying either a commission on products bought or a fee for time spent. In the past, many IFAs offered fee-based services, but many worked only on commission. In practice, most consumers prefer to go down the commission-paying route.

Customers must receive clear information about the service that the adviser is offering, including an upfront indication of the cost.

The Retail Distribution Review

The Retail Distribution Review (RDR) will be implemented by the FSA in December 2012. The Review proposes to introduce new categories of advice in financial services, to abolish commission-paid selling and to raise the standards of professional qualifications. The aim is to build trust and confidence back into the industry.

The new categories of advice will aim to help consumers to distinguish between forms of advice on offer to them, although cynics say it could muddle them more than now. There will be independent advice, which must be unbiased and unrestricted, with recommendations based on a fair and comprehensive view of the market. Restricted advice is provided when the firm can advise only on certain parts of the markets, such as its own products.

Streamlined advice consists of a new 'simplified advice' class, with enhanced professional requirements and adviser charging, and the existing 'basic advice', which involves advice on stakeholder savings and investment products and a very basic assessment from scripted questions.

Under the RDR as proposed, firms providing investment advice will have to disclose the nature of their services to customers in advance. The FSA will ban product providers from offering commissions to secure sales from adviser firms, and adviser firms from recommending products that automatically pay commission. Firms giving investment advice must set their own charges. Many are nervous about how customers will respond to this.

The FSA will create a Professional Standards Board (PSB), although some fear that this could duplicate some of the regulator's own work.

The financial services industry's benchmark qualification will be raised, and all advisers must reach it by 2012. There are uncertainties about how people will reach this qualification and some financial advisers are waiting to see whether the Conservatives, should they gain power, will abolish the RDR, as they plan to do with the FSA, although it seems unlikely. A code of conduct will be created and the FSA with the PSB will consult on consistent standards of continuing professional development.

The overall costs of the RDR are an estimated £430 million, of which £120 million is related to professional qualifications.

The Insurance Mediation Directive

The Insurance Mediation Directive (IMD) was implemented in the United Kingdom and three other EU countries by the January 2005 deadline, but in

other countries later. It introduced minimum professional requirements for insurance intermediaries across Europe, and required that consumers should receive specific information before they conclude a contract. Insurance intermediaries must be registered with a competent authority in their home member state, enabling them to offer cross-border services on a single passport. Complaints procedures must be available.

EU countries have taken different approaches to the IMD, and there has been significant gold-plating of the Directive's minimum requirements (that is, regulation in the home state has gone beyond the rules laid down at EU level). In the United Kingdom, the Directive was expensive to put into practice.

Complaints and compensation

The Financial Ombudsman Service

If a financial services firm, including a stockbroker, has operated incompetently or dishonestly, private investors should first complain to the firm. If this does not get a satisfactory result within eight weeks, there is in most cases access to the Financial Ombudsman Service (FOS), which is an independent organisation with statutory powers to settle individual disputes between consumers and financial services companies.

Every year, the FOS deals with about a million enquiries and settles 100,000 disputes, and the service is free to consumers. Most cases are resolved within six to nine months. Consumers do not have to accept any decision by the FOS and can go to court instead. But if they do accept the decision, it is binding on both them and the business.

Financial Services Compensation Scheme

The Financial Services Compensation Scheme (FSCS) is a statutory fund of last resort, funded by levies on authorised firms. It pays compensation for financial loss if an authorised firm is in a state of default and so cannot meet the costs of compensation claims. The FSCS protects deposits, insurance policies, insurance broking, investment businesses and home finance.

The scheme pays up to a set maximum level of compensation, and has recently upped its total limit for depositors. This is now 100 per cent of £50,000 per person on deposits. The maximum payable on investments is £48,000 per person, including 100 per cent of the first £30,000 and 90 per cent of the next £20,000. On home finance, such as mortgage advice and arranging, the maximum payable is £48,000 per person, with a similar breakdown. The most

paid on general insurance is 100 per cent of the first £2,000 plus 90 per cent of the remainder of the claim. On compulsory insurance, such as third party motor, the scheme pays out 100 per cent of the claim.

The future

In a July 2009 report on mass-market approaches to retirement income from Consensus Research (Young, White and Nemchand, 2009), commissioned by the Association of British Insurers, it was found that engagement with retirement income planning was very limited, and more comprehensive planning only started a short time before retirement. Participants tended to make decisions alone or turned to friends and colleagues, rather than financial advisers or the government. The experience of poor financial advice had a significant impact on their perception of the value of that advice.

Financial services professionals accept that their industry is not perfect, but see it as worrying if people prefer to take investment advice from their mate down the pub rather than from themselves. Financial journalism offers another source of information and guidance, although it is not always as independent or well informed as it may appear.

A possible long-term solution is to provide personal finance education to a younger generation that has not been exposed to the mis-selling in the industry, and the government has supported this. Since September 2008, 'economic well-being and financial capability' has been a programme of study within personal, social, health and economic education in England.

Pensions in flux

Introduction

In this chapter, we shall see how pensions and annuities work, and how they are affected by regulatory developments and the economic downturn of 2007–10.

Overview

The pension industry has an unfortunate reputation with consumers who rely on pensions for retirement. Past pension mis-selling and theft scandals have created significant mistrust, which came to the forefront, not for the first time, during the financial crisis of 2007–10.

Volatile investment performance and the issue of pension deficits added to the pressure over this period. At the same time, the National Association of Pension Funds (NAPF) confidence index rose from +3 per cent in the first quarter of 2008 to +7 per cent in the first quarter of 2009, indicating a small, but important, improvement in confidence.

Alongside this, employees still value their pensions. The NAPF workplace pension survey published in April 2009 found that 34 per cent of respondent employees in the first quarter of 2009 considered pensions the most important benefit their employer could offer on top of their basic salaries, up from 30 per cent a year earlier.

According to the NAPF, reforms such as the Pension Protection Fund and the Financial Protection Scheme, both compensation schemes, have meant that the UK pension system is one of the safest and most secure among those of countries in the Organisation for Economic Co-operation and Development. We discuss these schemes later in the chapter.

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Building on standards of investment governance

Horwath Clark Whitehill LLP partner Shona Harvie highlights where further guidance on investment governance arrangements is needed.

The current financial crisis continues to have a major impact on pension investments across the world, with volatility in investment values. The financial crisis is causing a shift in asset allocations, with many defined benefit funds looking at what are thought to be more 'conservative' investment strategies, which lock in current values but reduce the likelihood of upward and downward fluctuations in investment values. The values of money purchase pots are also under pressure, causing particular concerns for those close to retirement and reducing public confidence in making commitments to money purchase schemes.

Following the success of last year's survey, the Horwath Clark Whitehill Pensions Group have undertaken a further survey, *Building on Standards of Investment Governance*. This year's survey reflects on some of the issues covered last year and gives consideration to additional investment governance matters.

The results of the survey have been fed through to the Investment Governance Group which is a joint industry and government forum charged with issuing investment governance guidance to the pensions sector. The group aims to issue a small number of high level investment governance principles, including guidance and tools for trustees, for schemes of different types. These principles will build on the National Association of Pension Funds revised *Myners' Principles* which were published in November 2007.

There are many different definitions of investment governance. Essentially, 'governance' describes the way in which investments are administered and directed by the trustees in fulfilling their fiduciary duties. This includes:

- setting objectives and strategy;
- establishing and monitoring processes and controls;
- ensuring the scheme complies with relevant regulations;
- communicating effectively with advisers and members; and
- ensuring there are clear lines of accountability.

The ten key findings arising from the survey are summarised below.

1. The survey demonstrates that while the majority of members of money purchase arrangements invest in the default option, only one third will achieve an adequate retirement income. Governance around default funds should be a key focus area for the Investment Governance Group. Guidance would be helpful on the range of funds that should be made available to members, taking into account the members' profiles.
2. One half of respondents said that their attitude to risk had changed following the financial crisis, compared with only one third last year. This change in attitude is having an impact on investment strategies with more schemes considering downside protection and liability driven strategies. As strategies become more complicated so the need for greater risk management procedures increases, highlighted by the fact that 28% of respondents identified exposures they were not aware of when they decided to invest. Respondents requested guidance on risk management procedures and on assessing scheme investment risk, including counterparty risk and the security of assets.
3. A lack of transparency for hedge fund of funds, private equity funds and infrastructure funds continues to be a problem for schemes. Respondents felt that it would be helpful to receive guidance on how to deal with a lack on transparency from fund managers.
4. Surprisingly two thirds of respondents stated that they did not find it difficult to justify not following the advice of their investment advisers. In one quarter of cases respondents said that they had decided not to follow the advice of their advisers. Guidance would be useful on the extent of reliance that trustees are expected to place on investment advisers and the level of delegation that is acceptable. It is important to remember that trustees have ultimate responsibility for investments. Also clarity is needed on the extent of responsibilities, particularly for delegated fund manager and custodian arrangements.
5. Respondents requested more training material in the nature of complex 'investments'. Training tools would be useful particularly in areas such as investment governance, investment risk and counterparty risk, processes and controls surrounding investments.

6. For most schemes, other than large schemes with more resource, trustees were not considered to be the right people to vote on company matters and it is felt that shareholder voting is better left to the fund managers. Further guidance is clearly required to clarify the position on shareholder voting.
7. Clarity is required on the extent of delegation particularly for outsourced fund manager and custodian arrangements, and in particular where responsibility lies. Schemes should be reminded of the importance of monitoring the internal controls at their fund managers and custodians and guidance should be given on how to monitor these controls. Where internal control reports are not available trustees should consider what additional information they require to demonstrate that key risks have been mitigated. Guidance on the extent of such monitoring would be useful to trustees.
8. The Investment Governance Group could build on the recommendation of the Pensions Regulator and provide guidance on the areas that trustees should cover in a governance statement in the annual report.
9. As investment strategies become more complex trustees should consider whether the level of resource is sufficient to meet the increased governance requirements and should be reiterated in any guidance.
10. Most schemes do not have an investment governance budget and any new requirements introduced by the Investment Governance Group, should bear in mind the cost benefit to schemes.

If you would like to discuss the results of the survey further or are interested in an investment governance review of your scheme arrangements, please contact the Horwath Clark Whitehill Pensions Group (see details below).



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Let us first look at some of the scandals that have damaged public confidence in the industry, starting with what was perhaps the most egregious of them all.

Maxwell and the 1995 Pension Act

The 1991 Maxwell scandal undermined public confidence in pension management. Robert Maxwell, the wealthy owner of Mirror Group Newspapers, died in mysterious circumstances on a boat in November 1991, and his business empire collapsed. Maxwell had controlled 400 companies and often moved money between them. His debts vastly outweighed his assets. It turned out that he had stolen more than £400 million from 32,000 members of the group's pension scheme.

In 1992, two inspectors from the Department of Trade and Industry (DTI) were commissioned to investigate the Maxwell business empire and its collapse, and the flotation of Mirror Group Newspapers shortly before Maxwell died.

The DTI report found that in the months before Mirror Group Newspapers was floated, Maxwell had been taking money from the pension funds. Earlier in 1971, a Board of Trade investigation had found that Maxwell was 'unfit' to run a public company.

According to the DTI report, City institutions were partly to blame for the collapse of the Maxwell empire. These included Goldman Sachs, a broker to some of Maxwell's business, Samuel Montagu, which advised on the Mirror Group flotation, and Coopers & Lybrand, auditors to the Maxwell empire. The main responsibility, however, lay with Maxwell.

Since then the 1995 Pension Act has been introduced, under which, if money has been removed dishonestly from a pension scheme, an employer must ensure enough money is put back into the scheme to pay future benefits. If the employer is insolvent and cannot put back the funds, the pension scheme can claim up to 90 per cent compensation from the Pensions Compensation Board. Under separate legislation, custody of assets is regulated.

Pension mis-selling

Pension mis-selling has been a widespread problem. The Financial Services Authority (FSA) asked firms to review personal pensions that they sold between 29 April 1988 and 30 June 1994. In cases where the review found that the firm had mis-sold the policy and the customer would have done better to stay in or join an occupational scheme, the firm had to pay compensation which aimed to return the customer to the same position as if the firm had not advised taking out a personal pension.

The FSA also conducted a review of freestanding additional voluntary contributions (FSAVC). A FSAVC is a pension top-up arrangement you can

make with an investment firm, separate from an employer's pension scheme. This compares with an AVC, which is where you pay into a scheme run by your employer. The FSAVC review covered matched AVC schemes, where the investor could have benefited from extra employer contributions, and other subsidised AVC schemes, where the employer could have enhanced contributions.

In June 2002, the FSA released figures showing that the pension review was over 98 per cent complete. The FSAVC review had reached its target of 90 per cent of cases being dealt with by a June 2002 deadline. The regulator said, under the two reviews, 1.7 million consumers would have had their cases reviewed, and would receive compensation totalling £11.8 billion.

There are fears that pension mis-selling has since resurfaced, including the large number of transfers of pensions into the more flexible, but often more expensive, Self-Invested Personal Pensions (SIPPs). In November 2008 the FSA announced that it had fined financial adviser AWD Chase De Vere £1.12 million for 'serious failings' in its pension transfer, pension annuity and income withdrawal business, which resulted in mis-selling. The FSA found that the firm had mis-sold some pension transfers and annuities to customers who had adequate provisions already and who had the wrong risk profile. The FSA found the firm sometimes failed to disclose the risks and costs of the products it recommended, and could not always demonstrate the suitability of its advice from its own record.

There is industry concern that this firm got caught, but others are up to the same thing. Advisers moving from one firm to another bring clients with them, and advisers can earn high commission if they shift a customer from one pension to another.

Equitable Life

Equitable Life had its own mis-selling scandal. The society, established in 1762, had become one of the biggest mutual life insurers in the world, with 1.5 million policyholders. In the 1980s and the 1990s it prospered, providing impressive returns by selling through its own sales force and dispensing with commission to financial salespeople.

Appearances were deceptive. In January 2000 Equitable Life's management asked a court for permission to abandon a promise it had made to guaranteed rate annuity holders that they would have a guaranteed return on their investments. In July 2000, the House of Lords ruled that Equitable Life could not renege on its promise. Equitable had to put aside an extra £1.5 billion to make good its commitment, and it did not have the money. In December 2000 the society became closed to new business after it had failed to find a buyer. Hundreds of thousands of savers saw the value of their policies cut by the new management.

A report by Lord Penrose in March 2004 found that the society was the author of its own misfortune. The report said that Equitable's management was mainly to blame, and some regulators such as the Department of Trade and Industry had failed. Equitable Life had used 'dubious actuarial techniques' to make itself seem profit-making when it was losing money. The society's management had for many years told savers that their accumulated funds were worth more than was the case. The society was under-reserved.

In a second report on Equitable Life in July 2008, the Parliamentary Ombudsman, Ann Abraham, said that regulators had failed to protect policyholders and that ministers should set up a compensation fund for policyholders in Equitable Life.

In January 2009 the government said that it would compensate those policyholders hit hardest by the collapse. Opposition MPs and campaigners said that this was not enough. In July 2009 the Equitable Members Action Group went to the High Court to call for a judicial review around the government's decision not to offer victims of the mutual insurer full compensation as recommended.

The Turner Review

Financial advisers see such scandals as one reason why, on the government's own estimates, around 7 million people in the United Kingdom are not saving enough for retirement. Other reasons for this problem are the perceived lack of affordability of pensions, and the fact that many do not have access to a pension at work, a situation that will change in 2012.

The government established the Pensions Commission, headed by Adair Turner, to focus on the pension problem. The Turner Review was about people not saving enough, and whether employers and the state were doing enough to help people save for their old age. It was not about the security of pensions.

The Turner Review made its proposals in 2005. Based on these, the government has developed two packages for change: the state pension package, to be implemented through the Pensions Act 2007, and a proposal for Personal Accounts, a form of occupational scheme, not part of the Act but part of the same overall reform. We cover both in this chapter. Let us start by looking at the basic state pension.

The basic state pension

Pension arrangements in the United Kingdom start with the basic state pension. It is payable in full to those of the requisite age, which is 65 for men and from

2010 will also be 65 for women, and who have paid enough national insurance (NI) contributions over the years. There is an option to buy missing years through an amendment made in October 2008 to the Pensions Bill, which means people can now buy up to an additional six years of contributions above their current allowance.

The state second pension was introduced in April 2002, and provides an additional state pension. It replaced the state earnings-related pension scheme (SERPS), which was an earnings-related part of the basic state pension.

As an employee, you are included in the state second pension scheme unless you contract out: in other words, give up the entitlement and build up a sum instead in your own pension fund. HM Revenue and Customs rebate part of your National Insurance contributions into your personal pension. You are free to contract back in.

There are a lot of uncertainties about state pensions. This is overwhelmingly the biggest area of concern in queries to the Pensions Advisory Service (TPAS). In 2007–09 enquiries about the state of pensions, including how to become entitled to one, were up 100 per cent on the previous year. This accounted for 35 per cent of all enquiries, which included 61,935 calls to the TPAS helpline and 9,374 written inquiries.

State pension package

The Pensions Act 2007, which received Royal Assent in July 2007, is mainly about state pension reform. People will receive their state pension later than before. This will be on a phased basis. In 2024–26 they will start receiving a pension at the age of 65–66, and in 2034–36 they will start at the age of 66–67. In 2044–46 they will get it at the age of 67–68.

The basic state pension rises every year with the Retail Prices Index. From 2012 or slightly later it will rise instead with earnings, which should make the pension more generous.

To receive the full state pension, men must have made NI contributions for 44 years and women for 39 years, but from 6 April 2010 only 30 qualifying years are required in either case. According to the Pensions Advisory Service, the reduction will be of most benefit to women, who have tended to miss out. Anybody who has paid NI contributions for fewer years than required can make a proportionate claim.

The state pension provision does not pay individuals enough to live on comfortably after retirement. The government, by providing tax breaks, encourages people to take out their own pension as well.

Occupational and personal pensions

You may have an occupational pension, provided by your workplace, or a personal pension, or both. Either type of pension is a tax-efficient savings vehicle designed to provide you with a tax-free sum on retirement of up to 25 per cent of your accumulated pension funds, should you wish to draw on this, followed by a taxable income for the rest of your life. Your pension is a wrapper into which any funds may be put, and you get tax relief on contributions. Tax is paid on dividends but no additional personal taxation is payable until you receive your taxable pension income.

Defined benefit or defined contribution

Occupational pensions may be either defined benefit or defined contribution. A defined benefit scheme specifies the rate of benefits to be paid. The most common form is salary related, where the benefits are based on the number of years of pensionable service, the accrual rate and either the final salary, or an average salary, or the best salary before retirement.

A defined contribution scheme is where the contributions paid into the scheme, the investment return on the contributions, and the type of annuity bought at retirement determine the benefits.

According to 'Private pensions', an updated Chapter 6 published in June 2009 for *Pension Trends* (Pension Statistics Task Force, 2009), which was first published by the Office of National Statistics in 2005, the private sector has a mixture of defined benefit and defined contribution schemes.

Whether you have an occupational or personal pension, or both, your pension money is invested in funds. In a defined contribution scheme, you may choose the funds in which to invest, and in which combination, although in a defined benefit scheme, this is the responsibility of trustees. For those who want to avoid making decisions about their defined contribution scheme, a managed fund is available, which is balanced and not high risk, but for others there is a wide choice, including more exotic funds such as Far East equities.

In the long term there is a significant gulf between the best and the worst performing funds, but there is also a lot of copycat performance, particularly in the short term, with funds across the board suffering from short-term volatility in fluctuating stock markets. The Aon DC Pension Tracker found that at the early stages of the credit crunch in September 2007, the value of Britain's defined contribution assets stood at £550 billion. However, 16 months on at the

end of January 2009, the value had been slashed by over a third (25 per cent) to £410 billion.

Investors tend not to shift from the dud pension investments into better ones. Many leave it to pension providers or financial advisers to look after their interests, which can be a mistake. Some older pensions even have penalties for switching funds or for stopping and restarting contributions. In modern pensions, there is typically flexibility to move between funds. In the case of policyholders who take their benefits at a time other than their selected retirement age, a market value adjustment in some cases has been applied to the fund.

Since 6 April 2006, known as A Day, anybody has been able to contribute up to 100 per cent of their earnings to any pension scheme, subject to an annual allowance, which is £245,000 in 2009/10, rising to £255,000 in 2010/11.

The maximum allowable pension of two-thirds of final income was replaced by a lifetime allowance. This is £1.75 million for 2009–10 and will be frozen at £1.8 million between 2011/12 and 2015/16. Any pension fund above this level is taxed.

The A Day rules made it easier to mix personal and occupational schemes. Employees may take pension benefits while they remain at work and, if they wish, accrue a further pension. From 6 April 2010, the earliest age at which you can withdraw a pension is 55.

Let us now take a closer look at how occupational and personal pensions work.

Occupational pension

In the workplace, employees value occupational pensions, even with some poor performance of pension funds during the 2007–10 financial crisis. Long-term performance can smooth out short-term volatility and, besides, the risk in defined benefit schemes lies with the employers, so any deficit does not directly affect the employees. According to the fourth NAPF workplace pension survey, published in April 2009, 39 per cent of those already saving for retirement believe that pensions are the best way, ahead of property (20 per cent) and ISAs (16 per cent).

Not everybody has the chance to participate. A company does not have to operate an occupational pension scheme, although the rules will change in 2012, with the introduction of Personal Accounts (see below). Companies with five employees or more must at least offer a stakeholder pension (see below), but do not have to contribute to it, although they often do.

If an employer runs an occupational pension, the employer sponsors it and usually makes contributions, while a board of trustees runs it. As an employee, you may contribute to the pension, and may top up these payments with AVCs.

An occupational scheme often has other benefits, such as life insurance and a pension if you should retire early because of poor health.

Many employers pay for the scheme's administration, rather than taking the cost out of the fund. In many public-sector schemes the employer makes all the contributions. Most occupational schemes are contracted out, which affects members' entitlement to a second state pension (see above).

An occupational pension may be final salary, which comes into the category of defined benefit, where the pension provision is a proportion of your salary when you retire. It may otherwise be money purchase, also known as defined contribution, where the value of the pension is defined by the value of the funds built up.

Defined contribution schemes can be trust based or contract based, whereas final salary schemes are only trust based.

In the traditional, trust-based occupational scheme, there is a relationship between the employer, members and trustees. The employer will have established the scheme and a trustee manages it, collecting contributions, making pension payments and holding the scheme assets.

Contract-based direct contribution schemes typically include personal pensions, group personal pensions and stakeholder pensions. Here, an insurance company or other financial institution establishes the scheme and has a contract directly with the members. An employer is not a party to the scheme, although it may pay contributions to the provider and deduct members' contributions from the payroll.

Final salary (defined benefit) schemes

From the employee's perspective, the final salary scheme is seen as the best type of occupational pension because the employer takes the investment risk, there is some predictability about how much the pension will be, and the pension income will usually rise annually. If the final salary scheme runs short of cash, the employer must increase its contributions, and the Pension Regulator, which has the role of regulating work-based pension schemes, can enforce this.

The final salary pension that you receive is calculated according to how many years you have been a scheme member, your final salary before retirement, and an accrual rate, which is the fraction of final salary earnings allowed for each year of membership. People who receive a pension after 40 years of membership on a 1/80th accrual rate could expect it to be half their final salary.

A final salary scheme can be a perk of working in the public sector. According to an October 2008 Pensions Policy Institute paper, *An Assessment of the Government's Reforms to Public Sector Pensions* (Steventon, 2008), the

main public-sector pension schemes are nearly all defined benefit. The paper said that employers contribute about £4,000 a year per employee in the public sector, compared with £1,600 per employee in the private sector.

Public-sector final salary schemes may be funded, where the employers and employees also contribute to a pot of cash, much as in the private sector. They may be unfunded, where the government meets liabilities from future taxation. The local government schemes are funded, but many of the other public-sector schemes are not. In the unfunded schemes, there are concerns about the high rate, 3.5 per cent a year after inflation, used to discount future liabilities on an accumulated percentage basis. This gives the pension liabilities a present value that may be unrealistically low, and so puts insufficient financial pressure on the pension provider for meeting its liabilities.

In both the private and the public sectors, the cost of providing final salary pension schemes is now considerable given that employees are living longer. In the private sector, many employers have shut down their schemes. Lane Clarke & Peacock, a consultancy firm, said in mid-July 2009 that the shortfall in FTSE-100 blue chip final salary schemes had more than doubled to £96 billion in the past year, up from £41 billion in the previous year's survey. The fall in equity markets and the backlash from the Lehman Brothers collapse had taken their toll. Among FTSE-100 companies, only Cadbury, Diageo and Tesco continue to offer defined benefit pension schemes to existing and new staff. In cases where defined benefit pension schemes have been closed down, new staff are typically offered defined contribution pensions.

In July 2009 the FSA told 495 staff that they would no longer be able to contribute to its final salary scheme and would be moved into a defined contribution pension, which already had more than 2,000 FSA members. To reflect the impact of the change in benefits, final salary scheme staff was to receive a 10 per cent rise in salary as part of the new terms. The FSA had closed its final salary scheme to new staff in 1998, but still had many staff on the scheme, and aimed to move all FSA staff onto a common pay and reward system.

When final salary schemes are inadequate or the scheme becomes insolvent, two compensation schemes are available. The first is the Financial Assistance Scheme (FAS), managed by the Board of the Pension Protection Fund. It helps individuals who lost pension rights because they were members of qualifying underfunded final salary pension schemes that started to be wound up between 1 January 1997 and 5 April 2005. The second compensation scheme available is the Pension Protection Fund, which provides compensation in relation to final salary schemes that started to be wound up from 6 April 2005.

The Pensions Regulator has a key objective of reducing the risk of claims on the Pension Protection Fund.

Buy-ins and buyouts

A buy-in is for defined benefit schemes run by employers. It is the purchase of an annuity contract with an insurance company to match some or all of a pension plan's liabilities and therefore reduce risk. Until the collapse of Lehman Brothers in 2008, the price of buy-ins for pensioners was low. According to *Pension Buyouts 2009*, a report on buyouts by UK defined benefit pension plans by Lane Clark & Peacock, in the first part of 2008, buy-in prices for pensions were often lower than funding reserves agreed between trustees and companies, and this meant pensions could transfer investment and longevity risk to an insurance company without increasing their funding deficits or needing accelerated cash contributions to the pension plan. The report found that many deals were pensioner buy-ins, given that most pension funds could not afford a full buyout, which is where a pension plan's liabilities are transferred to an insurance company. After the Lehman collapse, there was significant rise in buyout prices, the report noted (Lane Clark & Peacock, 2009: 6, 8).

Money purchase (defined contribution) schemes

In a money purchase (defined contribution) scheme, cash is invested in a retirement fund to create a pot of money for the employee on retirement. The employee may take out a tax-free sum of up to 25 per cent of the fund, and the remaining money is used to buy an annuity, unless alternative arrangements are made (see below). The size of the pension depends significantly on how well the retirement fund has performed.

Group personal pensions are not trust based, like occupational pensions, but are contract based. The contract is between the pension provider and the individual. The employer usually pays into the scheme, but does not have to, and may be able to negotiate favourable group terms from the pension provider. See also below under 'Personal pensions'.

Personal Accounts

The National Pension Savings Scheme (NPSS), based on part of the Turner proposals, is the government's plan to make retirement saving the norm in the United Kingdom. With the scheme's introduction in 2012, employees will for the first time have the right to a workplace pension with matching contributions from their employer. Employees will be enrolled automatically in their company

pension scheme if one exists, or if not into Personal Accounts, which are a large form of occupational pension aimed at low to moderate earners (£5,000 to £33,000 per annum) who are not now in a company scheme. Employers will contribute 3 per cent of an employee's salary, and employees will pay in a further 4 per cent, with 1 per cent tax relief from the government.

The pensions industry supports the concept of Personal Accounts, but has expressed concern that employers could use them as a cheaper alternative to their current occupational scheme. They might offer only Personal Accounts to new recruits or to employees not currently in the occupational scheme. The government has said, however, that Personal Accounts are designed to complement and not to compete with the existing company pension provisions.

The Investment Management Association (IMA, 2009b: 8, 9, 10), in a response to a think piece published by the Personal Accounts Delivery Authority (PADA) on the future of Personal Accounts, warned that the commutation and education challenges around the introduction of Personal Accounts should not push the PADA into 'reckless conservatism'. The danger of pursuing a very cautious strategy, as in gilts, for the Personal Accounts default fund, would be that retirement outcomes could fall short of expectations, both in absolute and relative terms. The IMA noted that the default fund for the Thrift Savings Plan in the United States, a defined contribution federal employees' pension scheme, had been established as a safe fund, investing in specially issued Treasuries, but this was being changed. The life cycle funds, with significant equity exposure, had turned out to be a more significant default option.

In its response to the PADA paper, the IMA (2009b: 12) noted evidence that the target market for Personal Accounts had lower than average earnings, uneven employment histories and low risk-seeking characteristics, although the overall membership would still be fairly heterogeneous. The IMA said that individuals might have a propensity to discontinue contributions in a context where employers may not be actively engaged, and that individuals would expect not to have suffered any loss in real terms on individual contributions made.

According to the IMA response, it is critical that the investment strategy of the default fund should focus on the long-term interests of its members rather than being driven by concerns about how they might react to that strategy.

Personal pensions

A personal pension is usually a money purchase scheme (see above). You can buy it independently of the workplace and it has no employer contributions, but

is portable and flexible. A personal pension may be suitable if you are self-employed or do not have a workplace pension.

You may buy your personal pension directly from a provider or through an independent adviser, who will help you to select from the wide range of options available.

Stakeholder pensions

The stakeholder pension, introduced on 6 April 2001, is a cheap and flexible form of personal pension, which must meet specified criteria. The government designed the product to encourage savings through pensions and to make them more accessible and affordable to middle-income individuals.

You can pay as little as £20 a month into your stakeholder pension, or in some cases less. Unlike with some personal pensions, there are no penalties if you miss payments or move your fund to another scheme.

Like any personal pension, the stakeholder pension provides the option of taking a tax-free sum of up to 25 per cent on retirement and buying an annuity with the rest of the pension pot. The stakeholder element focuses on the fairness of the wrapping and not fund performance.

The cap on stakeholder charges was raised in April 2005 from 1 per cent to 1.5 per cent (falling to 1 per cent after 10 years). The permitted rise in charges boosted sales because it gave advisers a greater financial incentive to recommend the product, but the charges are still low.

A disadvantage in the stakeholder pension is that it tends to offer conservatively run in-house funds, without the wider choice available through other forms of personal pension.

Self-invested personal pensions

An active investor may opt for a self-invested personal pension (SIPP), which enables them to choose where to invest from a wide universe, including investment funds, shares and commercial property, and to switch investments. It is possible to employ an investment manager to make these decisions.

Charges on a SIPP are levied on the underlying instrument. There are also charges on the wrapper, although these have declined from earlier levels.

Since April 2007, the FSA started to regulate the operation of SIPPs and the sales advisory process. It has warned financial advisers not to be influenced by the high sales commissions into advising customers inappropriately to buy a SIPP, a problem on which the press had been focusing some attention.

Annuities and unsecured pensions

Annuities

When you retire, the bulk of your defined contribution pension fund may be used to purchase an annuity. This is a contract from an insurance company that converts your pension fund into regular income that you will receive for the rest of your life. Since 6 April 2006, an annuity purchase has been optional.

If you are buying an annuity, you may first take out a tax-free sum from your pension pot, which, as we have seen, may be up to 25 per cent of the fund. You then use the rest of your capital to buy the annuity. Your capital passes to the annuity provider, an insurance company or similar specialist company, which in return then pays you an income until you die.

With annuities, the level of income received depends on the annuity rate at the time of conversion, which is derived from a range of factors, including average life expectancy and the long-term interest rates on government bonds. As a general rule, the older you are, the higher the annuity rate should be, bearing in mind that rates can fall and rise.

As an annuity buyer, you have the right to exercise the Open Market Option (OMO), which is the right to buy your annuity on the open market, where you may well get a better rate than from the insurer with which you kept your pension pot. The annuity can vary significantly between providers, and you should shop around to find the best deal.

According to the Pensions Advisory Service in its report *Advising on Pensions: A Review of Activities 07/08*, research has shown that as many as 58 per cent of members who retired from defined contribution schemes did not use their OMO.

Pension providers must send 'wake up' packs at least four months before a person is due to retire, setting out the options and explaining the potential benefits of the OMO. In some cases, it does not make sense to exercise the OMO. For instance, some pensions have guaranteed annuity rates that can provide a level of retirement income higher than a standard annuity. But annuity buyers should always be aware of the OMO and how it works. In 2008, the FSA gave a warning to pension providers after it found that 40 per cent of them had not met basic standards for providing guidance on how to buy an annuity through the OMO.

In August 2009 Friends Provident, the life insurer, when presenting its half-year results revealed that 4 out of 10 of its retirement savers had bought an annuity with the company. At the time, however, it was one of the worst-performing of all insurance companies, as commentators in the press noted. A

65-year-old man with £50,000 in pension savings at the time could buy a level annuity paying the same income every year. He could receive £3,084 from Friends Provident or alternatively £3,528 from AEGON Scottish Equitable, the best annuity rate provider. Friends Provident made the point that much of its retained business was for amounts of less than £10,000, where the saver found it difficult to shop on the open market.

A level annuity pays the same income annually, but it can make more sense to have an escalating annuity, which pays a lower starting income that rises every year, either by a fixed amount or in line with inflation. A further variation is a guarantee that payments will be made for a minimum period, even if you die in that period. A single life annuity will not pay a remaining income to anyone after your death, but a joint life annuity will pay income after you die to your partner for their lifetime.

Some people can benefit from enhanced and impaired annuities. People with a medical condition that could reduce life expectancy, such as cancer, or who have smoked at least 10 cigarettes a day for 10 years, could qualify for these products, subject to medical underwriting. These products can offer a higher income than standard annuities. In August 2009, consultants Watson Wyatt noted that enhanced annuities made up close to a third of all annuities sold in the open market in the United Kingdom. The firm expects the growth of this market to have implications for the pool of healthier lives that do not qualify for an enhanced annuity.

In a phased retirement, the retiree converts their pension fund into annuities in different stages. Some personal pension funds are a single plan, but others are a cluster of plans called segments, which the holders can use to buy lifetime annuities at different times. When they convert a segment to an annuity, they can take part of it as tax-free cash.

Insurers have in some cases taken 10 weeks to transfer pension pots to annuity providers, which gives the insurers extra interest but means that, should annuity rates fall, investors lose income. Annuity quotes are valid only for 14 days. The transfers can take a long time despite the introduction of Options, an electronic transfer system, which the Association of British Insurers (ABI) says has cut transfer rates down to eight days from an average of 31 days. So far 16 providers, accounting for more than 90 per cent of annuity business, are participating in the initiative.

The EU Solvency II Directive (see Chapter 28), in its present draft form, is likely to reduce annuity rates. The United Kingdom is particularly affected because it has the largest annuity industry in Europe due to its requirement for people to buy an annuity at age 75. In most other European countries, those who have retired can take their retirement savings as either a lump sum or drawdown past the age of 75, which means that annuities sales are lower.

At present, most UK companies back their annuity business with corporate bonds. They calculate Solvency I reserves according to the yield on these bonds, less a prudent margin for expected defaults. Under Solvency II draft proposals, the swap curve, meaning the yield curve created to show the interest rates charged at various maturities for swap agreements, will be used as the risk-free rate in calculating the best estimate liabilities, and this will change how insurance companies will manage mark-to-market volatility. They will either have to hold additional capital or change the assets used to back their liabilities, which could mean investing in government securities, which are more expensive than the corporate bonds they now use. In addition, a risk margin will have to be included, which seems very high, and no allowance will be made for diversifying between different lines of business.

Large annuity providers are lobbying on the use of swap rates as the risk-free rate and on the risk-margin calculation. The ABI and major UK insurers, including Legal & General and the Prudential, have raised concerns about reduced annuity rates, which would affect some 6 million people in the United Kingdom who are saving through defined contribution pension schemes.

The UK government is not, however, lobbying on the issue at the same high level of individual representation as Paul Myners, the City minister, as showing for its defence of hedge funds from draft EU legislation. There has been speculation that the government's lack of strong lobbying is linked to its short-term interest in selling gilts in the financial crisis.

If the lobbying fails, annuities could become much more expensive. If corporate bonds are considered no longer suitable for annuity investment, it will affect the market broadly. Companies will have to seek forms of funding away from bond issuance into areas such as bank loans.

In his June 2009 address to the ABI 2009 conference, which was an insurance audience, Adair Turner, chairman of the FSA, said that private annuity provision could become more important as defined benefit pensions continued to decline and defined contribution pensions requiring annuitisation grew in importance. He said that a prudent approach to annuity capital requirements was important, but so was the recognition that the annuity business in particular was different from the business of banking, not subject to liquidity risk, and specifically focused on matching long-term liabilities with long-term assets. He said the challenge was for the industry to get involved in the debate.

Unsecured pension

An unsecured pension involves short-term annuities or income withdrawal, and you can combine the two. You may use some of your pension fund to buy a short-term annuity, leaving the rest of your fund invested, with the volatility that

arises from its exposure to equities. At the end of the annuity's term, you may buy another short-term annuity.

With income withdrawal, you draw a taxable income from your pension fund, which is up to 120 per cent of the income that you would receive from an equivalent level single-life lifetime annuity. The rest of your fund stays invested, again with the exposure to equities. The amount that you take from your fund must be reviewed every five years to ensure it is within HM Revenue and Customs limits. At any time, you can stop income withdrawal and use the rest of the fund to buy an annuity.

If you have an unsecured pension by the age of 75, you must secure an income from your pension funds – usually a lifetime annuity, but it may also be used to buy an alternatively secured pension (ASP). The ASP is similar to an unsecured pension, but with different rules, and has been available only since 6 April 2006.

From 6 April 2007, the government has stopped ASP funds passing tax-effectively to non-dependent family members as a pension scheme. Any such payment would now be unauthorised, and could be subject to a tax charge of more than 80 per cent.

Final word

In his June 2009 speech at the ABI conference, Turner (2009c) said that there should be an opportunity to promote pensions because the savings rate was rising. He noted that so far, most new savings were going into bank deposits or mortgage debt rather than long-term savings products, and that the challenge was to design and distribute products which enable people to develop a more diversified form of wealth creation than before. To be successful, the industry had to overcome its long-standing structural issues, the problems of poor persistency and high distribution costs reducing pensions' profitability, and perhaps above all, to respond to consumers' call for less complexity.

Pensions are not the only source of retirement income for many people. In July 2009, consultants Watson Wyatt announced research that found the non-pension assets of those reaching retirement age would grow considerably. The non-pension assets included in its study are residential property equity, cash deposits, life investment bonds, cash ISAs, and stocks and shares ISAs. The research found that the sum of these assets far exceeded the accumulated pension savings that underpinned the 'at-retirement' market. These non-pension assets approached four times the size of the accumulated pension savings, and this gap was predicted to remain over the medium to longer term.

The shipping industry

Introduction

In this chapter, we shall focus on London's role in the international maritime industry, and how shipping companies, brokers, charterers, banks and others work together. We shall look at the Baltic Exchange, freight derivatives, and briefly at marine insurance. We examine the role of the International Maritime Organization (IMO) and conclude with a look at major industry issues, including climate change and piracy.

Overview

London is a leading supplier of services to the international maritime industry. According to *Maritime Services 2009*, a report published by IFSL Research (McKenzie, 2009b), London's 400 shipbroking firms generated net exports of £948 million in 2008, up 23 per cent on the previous year.

In the sale and purchase market, the London shipbrokers match ships with cargo and are involved in the sale and purchase of more than half the world's tonnage. The broker negotiates a rate acceptable to the ship owner and the charterer, and also helps buyers and sellers to complete their contracts. Brokers are paid a low-to-medium salary, with bonuses for good performance, and they work in a close-knit community. Some of the bigger London brokers include Clarkson's, Simpson Spence & Young Ltd, Braemar Seascope and Galbraiths Ltd.

In some cases, vessel operators sublet the vehicle. The charter pays the shipping company to use the vessel. In its turn, the shipping company pays the broker commission and takes on the cost of running the ship, including port and crew costs; it may hire ship management for their technical expertise and looking after the crew, or it may do this work in house. The banks provide

finance, including to the listed shipping companies, which also have other ways of raising cash.

Much of the physical bulk shipping market operates like a taxi service. The ships go where the cargo needs to be taken. This cargo may be dry bulk, such as grain and coal, or wet cargo, such as oil. Ships come in different shapes and sizes, for example ro-ro, car carriers, dry bulk carriers and chemical tankers, oil tankers and gas carriers. Container ships carry boxes of manufacturers' goods and a huge range of other items from frozen foods to motor cars; they are a scheduled service rather than a taxi.

Ship finance is big business. According to the IFSL report, at the end of 2008, UK banks had US\$50 billion in commitments, which was 13 per cent of the world's business, down from 16 per cent in 2006.

The shipping market is fed with information by the Baltic Exchange, which is not an exchange. It started out in the 18th century as a coffee house and is now a community of 580 members, including ship owners, charterers, shipbrokers, banks, lawyers, insurers and others. The Baltic Exchange operates a members' code of conduct which, for example, prohibits a shipbroker from agreeing a deal and then abandoning it in favour of another.

As a main part of its role, the Baltic Exchange provides data on the cost of moving cargo by sea on a spot basis, and provides this to end users. It has received this data from panels of shipbrokers around the world which give a professional assessment on rates achieved by a range of vessel types on a variety of trades.

Freight derivatives are a way to hedge exposure to freight market risk. Forward freight agreements (FFAs), as the derivatives are known (there are also options on them), are on the cargo transportation cost, both on the dry side, as in grain or iron ore, and on the wet side, mainly crude oil. The contracts are cash settled, with no physical delivery of freight. The forward pricing might be, for example, on the cost of moving iron ore from Brazil to China, and is always based on the daily rate in US dollars for the vessel hire. Settlement is computed against estimated prices, published by the Baltic Exchange, based on the assessment of shipbrokers.

Speculators as well as hedgers use FFAs, which are a fairly liquid instrument, and this has helped the market's expansion. Some of the major banks are traders, and among these is Morgan Stanley, which also has a position in physical shipping.

Since about August 2008, FFAs have moved mainly from over-the-counter (OTC) trading on a principal-to-principal basis to central counterparty clearing, a migration that the Baltic Exchange has attributed to the financial crisis. There had been some defaults by counterparties in FFA trades, but in all cases these were linked to the physical market.

Financial crisis

The financial crisis of 2007–10 has hit the shipping industry. It had previously experienced a bubble, but a price problem arising in the market has led to an erosion of trust. As happened in the banking sector during the 2007–10 financial crisis, shipping sales slowed. Ship owners cancelled orders, paying the requisite penalty clauses, which led to write-downs on the balance sheets of ship makers and defaults on loans by major banks. New orders declined, including in dry cargo where they had reached a particularly high level. The Baltic Dry Index, a daily average of the cost of raw material, collapsed from 11,793 on 20 May 2008 to a record low of 663 in early December of that year.

In a March 2009 report on shipping markets (Sernder and Kindahl, 2009), rating agency Standard & Poor's (S&P) noted that rapidly deteriorating conditions were squeezing the ratings on European banks exposed to the shipping industry, and it expected the difficulties to result in a material increase in banks' loan loss provisions. S&P found that European banks were especially exposed to dry bulk and container shipping. The report found that fluctuating second-hand ship prices could suggest a potential recovery risk on assets used as collateral for bank lending.

According to the International Chamber of Shipping (ICS) *Annual Review 2009*, by spring 2009, some 10 per cent of the containership fleet had been laid up, and much of it was too modern to go to recycling. The review said that, by April 2009, many oil tankers were also failing to cover their operating costs, rates for product and chemical tankers had fallen sharply, and the dry bulk trade was also seriously affected, particularly due to reduced raw materials demand from China. Spot market freight trades for some bulk carriers were, according to the review, a fraction of the peak prices achieved in 2008.

In an April 2009 review of the shipping crisis, Consultants on Maritime Transport (COMT) said that this downturn was more severe in certain sectors of the shipping market than in the earlier shipping crises of the 1970s and 1980s. COMT said that many ship owners had profited over the previous five years from ordering two ships at a time, knowing that, before or at delivery, they could sell the extra ships they did not need at a profit. According to COMT, some ship owners had created special-purpose publicly quoted vehicles to raise equity to help buy vessels, which have sometimes been sold into their personal fleet, often at a contrived price.

In October 2009, Michael Tamvakis, professor of commodity economics and finance at Cass Business School, said in conversation with me at Complanet that shipyards receiving order cancellations are left with raw material, including steel in bulk or layered onto a partly built ship. 'They sell some of their inventory in blocks so they can raise some capital when orders are cancelled. It's a function that helps everyone.'

Shipping prices remained in decline. Tamvakis noted that in the first quarter of 2009, ship owners had been able to order vessels priced 15–20 per cent below the level a year earlier. By the third quarter, prices for some vessel types had fallen 25–30 per cent from the third quarter 2008, which was the peak. ‘All ship builders are having difficulties, but the ones who find it easier are the sophisticated builders, often in Japan or Korea. The builders of standard vessels in China are hit hardest.’

According to the *Maritime Services 2009* report (McKenzie, 2009b), the notional value of FFAs traded by shipbrokers in OTC derivatives reached a record US\$163 billion in 2008, but was expected to plummet to US\$40 billion in 2009. According to the Baltic Exchange, by the fourth quarter of 2008, derivatives had reached twice the volume of the underlying physical freight market.

Tamvakis said that when a crisis should hit, people were very quick to blame derivatives for price movements in the physical markets, but freight derivatives had nothing to do with the shipping crisis. ‘Supply and demand for vessels drives the physical market. Derivatives don’t make people buy vessels.’

Tamvakis noted that many blamed speculators for rising oil prices but, if investment businesses pulled out of the derivatives and the prices fell, the same people complained that liquidity had left the market.

Marine insurance (see Chapter 28) has been hit by the hugely unprofitable state of the shipping industry and also by piracy (covered later in this chapter). There have been rising claims. Deirdre Littlefield, president of the International Union of Marine Insurance, told delegates at the group’s annual conference in September 2009 that conditions for marine underwriters were stagnant, with the maritime sector ‘on its knees’, and that underwriters might feel tempted to cut rates and make other concessions to maintain market share. She said that discipline was vital for underwriters to assess and price their risks realistically.

Regulation of FFAs

In the OTC derivatives markets, as we saw in Chapter 8, there is a regulatory shift in favour of greater transparency and towards exchange trading. This will have an impact on FFAs.

The Baltic Exchange is opposed to exchange-traded derivatives, as it explained in an August 2009 response to an EC consultation, *Possible initiatives to enhance the resilience of OTC derivatives markets*. The response said that over the previous 20 years, many, if not most, new exchange-traded contracts had failed. ‘This is because unlike the evolutionary approach offered

by the OTC market, exchange contracts are completely standard from day one, and may not precisely meet the need of the market place.’

Jeremy Penn, chief executive at the Baltic Exchange, said in an interview with me at Complanet on 21 October 2009 (Davidson, 2009b) that he did not think a move to exchange trading should be imposed by an outside party on freight derivatives. He said that he considered it unwise to assume that a change that may be right for complex credit derivatives was necessarily desirable for freight derivatives. In his view, the OTC market had proved it could meet market needs. The FFA market uses telephone broking, which Penn said provided more effective price disclosure than an electronic system, to which regulatory interest was gravitating. He said that traders might disclose their interest via brokers when they were not prepared to place a firm bid or offer on an electronic marketplace.

Regulation of shipping

The IMO is a UN agency that regulates the technical aspects of the physical shipping industry globally, adopting regulations and standards that member state governments, including the United Kingdom, implement under national law. The IMO, which started operating in 1959, is financed by these governments, based on gross tonnage of the ships. The United Kingdom, inclusive of the Cayman Islands and Bermuda, is fairly high on the list, but below, for example, Panama and Liberia.

The IMO has a primary responsibility for safety at sea, and in recent years it has become involved in pollution from ships, maritime security and other issues, which are often related to safety. If a ship is made safer, this means fewer lives are lost, and reduces pollution incidents. Each IMO flag state issues certificates to ships signifying that they meet standards of safety. In addition, port states can inspect any ship, ask to see certificates, and if they see anything wrong, can require the ship to rectify any deficiencies before it sails from the port.

The IMO does substantial ongoing work on training, and as the third edition of this book went to press, was revising its international convention on standards of training, certification and watchkeeping for seafarers. This is about international statements of competency. New standards of competency have been introduced for natural gas carriers.

In relation to greenhouse gas regulations, the IMO, as a UN agency, can adopt regulations but not enforce them, and so it is dependent on the commitment of flag states. In general, flag states are responsible for establishing IMO international rules into their own national law, and for implementing and enforcing the regulations.

Global issues

The global nature of shipping gives rise to cross-jurisdictional issues, which different countries may view in their own way. In the area of climate change, no international rules to control greenhouse gas emissions from ships have yet been adopted, and seafaring laws vary. There is international agreement on cracking down on piracy, but countries such as Somalia, where pirates are based, have specific problems that make addressing the issue difficult. Piracy is not something controlled by IMO regulations, but is a criminal activity. Let us take a closer look at climate change and piracy in turn.

Climate change

Greenhouse emissions

As IMO research has traced, greenhouse gases are increasing, because of the burning of ever more fossil fuels, mainly oil and coal, and this is leading to a fast heating of the planet, which could bring about the extinction of animal and plant species. High temperatures will cause sea levels to rise, and this will affect coastlines.

Most scientists are agreed that it is important to address greenhouse emissions and related climate change issues now, and action can make a difference. Some US politicians have harnessed the cause. There are a few sceptics. Joan Ruddock, minister for climate change at the UK's Department of Energy and Climate Change, said at an Association of British Insurers (ABI) conference on climate change in November 2009 that some sceptics were financed by those who did not want mitigation measures, but there were a small number who did not share the scientific consensus that the global climate change threat was very real.

The UN Framework Convention on Climate Change with its Kyoto protocol provided that the reduction of emissions of greenhouse gases from ships should be pursued by the IMO. Since 2003, the IMO has intensified its work focusing on greenhouse gas issues, and in 2009 published a major related study, updating a previous study published in 2000 (IMO, 2009a).

So far, the IMO has agreed on technical and operative measures, and has distributed some for use, including a ship operator energy efficiency design index, which helps make the design of ships more fuel-effective. The IMO is exploring market-based instruments, including fuel tax and an emissions trading system.

The trading system would enable the buying and selling of carbon dioxide (CO₂) on credit, and would provide a financial incentive for lower emissions. If

the target value was 100 units, and a party emitted 100, this would be on target. If, however, it emitted 80, it would have 20 credits to sell, or if it emitted 120, it would need to buy 20 credits. According to proposals, some of the credit traded could go into a fund to help developing countries. A trading system needs indexes to show how much CO₂ ships are emitting, which links with the technical measures the IMO has distributed.

A decision to adopt such measures may have diverse implications, and it is the net effect that counts. As Efthimios E Mitropoulos, secretary-general at the IMO, noted in a message about climate change on World Marine Day 2009 (Mitropoulos, 2009: 2), if ships move more slowly, this would cut emissions, but more ships would be needed to deliver the same cargo as quickly. He said that there should be a holistic consideration of any proposed solution.

In 2009 the IMO publicised its concerns about greenhouse emissions by making ‘Climate change: a challenge for the IMO too’ a theme for the World Maritime Day. The IMO is working towards international shipping regulation that could help decelerate climate change and the threat of global warming, and it wants regulations on greenhouse emissions applied to all ships everywhere.

Any new regulations on reducing greenhouse gas emissions could affect supply in the shipping industry and have an impact on costs, according to Tamvakis. ‘This is not insurmountable. Ship owners will have to retrofit vessels. The biggest difficulty will be on the logistical, administrative side – on who will pay and how – because this is a very global industry.’

He noted that the shipping industry had already experienced such an effect with the changes in regulation that followed the 1989 *Exxon Valdez* oil spill. ‘There was some retrofitting there – with second skin on ships. Eventually, however, single-hull vessels were simply phased out and replaced by double-hull vessels. If there is a reasonable phase-in period then shipping should be less badly affected.’

Insurance

For the insurance industry, climate change is both a threat and a business opportunity. At the biennial ABI conference on 9 June 2009, Andrew Torrance, chief executive at insurer Allianz, described climate change as a systemic risk, such as those big banks must manage (Davidson, 2009d).

Lloyd’s is funding independent research into weather phenomena, as are Munich Re, Swiss Re and others (Munich Re, 2009, The Economics of Climate Adaptation Working Group, 2009 and Dyer, 2009). In mid-2009 Rolfe Tolle, director, franchise performance at Lloyd’s, pointed out at the London launch of a Geneva Association report on the impact of climate change on insurance that climate change could hit property insurance lines. This was not just because of the

size and frequency of weather-related events but also because of building in new locations. Climate change could mean economies suffer, crops do not grow, and that there is political change and social unrest. Insurers could be hit by insurance losses, as well as by investment losses on their bond and equity portfolios.

Tolle said that to send the correct economic signals to society, it was critical to charge insurance premiums on a risk basis, but in some regions there was interference with this. He said that Florida took the wrong approach.

Climate change will mean the insurance industry has to hold more capital as a whole under Solvency II, the EC directive, according to a November 2009 research paper, *The Financial Risks of Climate Change*, published by the ABI (Dailey *et al*, 2009). An ABI document focusing on the policy implications of the research notes that, if insurers were to hold more capital to cover higher expected losses, this would reduce the amount they have for investment, and the implications for capital flows would be of global significance.

Piracy

Modern-day pirates, operating off the Somali coast and elsewhere, appear to use sophisticated satellite communication and ship-tracking systems, although there is nothing so high-tech about their grappling hooks and small weapons. Piracy has received significant press attention, but industry sources suggest that carriers do not always report piracy; if they do, their insurance rates might soar and an investigation might prove costly.

The IMO has been addressing piracy since the 1980s, and has worked with the United Nations to coordinate action among interested parties, including governments, the European Union and NATO.

In January 2009, the IMO held a regional meeting in Djibouti, a country in the Horn of Africa, on maritime security, piracy and armed robbery against ships for western Indian Ocean, Gulf of Aden and Red Sea states. The meeting led to a code of conduct aimed at ensuring cooperation, with signatories undertaking to ensure that they had laws in place to prosecute pirates.

In the same month, a UN contact group on piracy off the coast of Somalia was established at the instigation of the United States, and it has become the focus of international efforts. In July 2009 the IMO revised its guidance on combating piracy, and in September 2009 circulated its updated *Best Management Practices to Deter Piracy in the Gulf of Aden and off the Coast of Somalia Developed by the Industry*.

In October 2009, in a keynote address at Lloyd's 260 live debate, 'Managing Risk in the 21st Century', Mitropoulos noted that pirates had been operating with success around the coast of Somalia and the Gulf of Aden, hijacking ships

and holding crews hostage. He said the pirates were well informed, including by networks of ‘consultants’.

Elsewhere, there are suspicions that such consultants operate from London, informing pirates which ships are delivering valuable cargos, where and when. There are some uncertainties around insurance protection against ransom. Tamvakis said:

There are two government positions on ransom. Many governments, including the United States, won’t pay a ransom under any circumstances, although private businesses might. The European position, however, is to negotiate a ransom, uncomfortable as it may be, because to pay this is cheaper than losing valuable cargo to the pirates.

There are some difficulties in obtaining insurance protection against ransom.

Ultimately, piracy is a symptom of deeper problems. In Somalia there is political unrest, and many young people are reportedly ambitious to become pirates. The Somali ambassador to the Russian Federation put a different case, however, to delegates at a 2009 Moscow reinsurance conference. He argued that some countries in the West were informing local pirates because they were trying to destabilise the region with a view to getting their hands on Somalia’s rich mineral and fishing resources.

Terrorism funding

Shipping experts are querying whether piracy is funding terrorism. The City was discussing the matter in early November 2009 as the Foreign Office said it was unwilling to pay the US\$7 million ransom that Somali pirates were initially demanding to release Paul and Rachel Chandler, a British couple travelling from the Seychelles to Tanzania.

A shipping expert, who insists on anonymity because of the sensitive nature of his revelations, told me he believed that piracy money was channelled through the Somali community in London to fund terrorism.

Related concerns have already become public. Lord Joplin, rapporteur of one of the committees of the NATO parliamentary assembly, told me that the government ought to increase its efforts to inquire whether ransom money from piracy has moved to fund terrorism. He said that a large percentage of the world’s piracy is in Somalia, which was said to have al-Qaeda cells, so it would not be a large surprise if it emerged that funds were going in that direction. Islamic principles claimed to be behind terrorist attacks are arguably incompatible with pirate activity, but some terrorists nonetheless wish to promote their cause by any means. The shipping expert said that to achieve resolution on

piracy and its possible links with terrorism, the UK government would need to take measures to:

- crack down further on financial activities that might help piracy, such as money laundering or drug and gun trafficking;
- pass legislation which explicitly forbade ransom payment by anyone, although this would raise problems if a company was registered in a third country and did not come under the European Union's jurisdiction;
- provide a lot more military resources to combat piracy.

The expert queried whether the authorities would find it worthwhile spending perhaps several hundred millions of pounds on a piracy crackdown only to save a few tens of millions potentially paid in ransoms.

However it may flourish, piracy will never stop shipping from operating, according to Tamvakis. 'It'll only make transport more costly, due to insurance or the need to take a longer route. Another approach is political intervention in the country, but this may cost a lot more.'

Tamvakis said that, in his view, piracy would leave the reputation of the shipping business intact. 'The only factor which causes reputational damage to the industry is oil spillage. Vessels have been going down and lives have been lost but nobody cares – it's only a casualty. But when fish are spoiled by oil, it's seen as an environmental hazard.'

Seafaring laws

Seafarers are exposed to different laws, and some jurisdictions impose criminal sanctions for pollution even when no misconduct was intended. In the *Hebei Spirit* oil spill case, two officers in late 2008 controversially spent some time in a South Korean jail after a major oil spill when their tanker, while at anchor, had been rammed by another vessel. They were later released but not allowed to leave South Korea. As the third edition of this book went to press, the matter was not fully resolved.

According to Tamvakis, exposure to different applications of the law across the globe is part of the life of shipping. 'There is agreement on legislation but it is translated into local language, and countries act on the same laws differently in individual cases.' He says that there are many examples of potential differences. In South Korea, for instance, legislation is simple because one country is involved. 'In the United States, there are federal and state laws, and one state can have different laws from another. In one state, there is limited liability for an oil spill and, in another, unlimited liability.'

The future

There are fears that governments could respond to the shipping crisis by protectionist means, potentially using safety and security as a pretext, which could damage the industry's growth. Unlike most industries, shipping is not yet covered by a global multilateral trade agreement.

Tamvakis agreed that protectionism was a potential threat to shipping. 'If you're trying to reduce trade and the market for goods, shipping will be hurt. The problem is in agricultural commodities where a lot of countries are self-sufficient and don't want to open up trade.'

Raw materials other than food, however, have driven the freight market since 2004, according to Tamvakis. 'With coal or steel, there is no problem with protectionism. These products are, however, affected by the financial crisis, which hit demand and reduces production, meaning there is less need for raw materials.'

According to Tamvakis, the financial crisis has led to a lack of movement in the second-hand market for ships, as evidenced by the decline in publication of reports on second-hand prices from some major brokers. 'It seems likely that people bought ships at the peak of the market and are not willing in 2009 to sell out at a much lower price. There is more scope for new ship-building orders than second-hand trade.'

In the long term, prospects for the shipping industry are sound. According to the *ICS Annual Review 2009*, the world's population continues to expand, and emerging economies will continue to increase their requirements for goods and raw materials that shipping transports.

Catching the Iceland chill

Introduction

In this chapter, we shall look at Iceland's banking crisis and the repercussions, particularly in the United Kingdom, where Icelandic banks established operations. We shall examine perceived flaws in European regulations that the Icelandic crisis has thrown up, and how this has had an impact on the United Kingdom.

Internet accounts

In the run-up to, and during, the credit crisis, many UK retail depositors became exposed to Icelandic bank problems by depositing money in the country's internet retail bank accounts, which paid higher rates than the norm. In October 2006 Landsbanki, a large Iceland bank, launched Icesave, its internet banking operation. In January 2008 Kaupthing, another large Icelandic bank, introduced its Edge accounts, also on the internet, into the United Kingdom.

The initiatives seemed at first instance a master stroke by the Icelandic banks to expand deposit taking, which is considered a more stable source of bank funding than the equity or debt capital markets, and some rating agencies applauded it. In an Iceland mini-crisis, which reached a peak in March 2006, concern had arisen about the leverage in Icelandic banks, however, and rumours had circulated that investors were taking short positions in both banks and companies. The spreads of credit default swaps exposed to Icelandic debt had started to broaden, which by definition meant that protection against default was becoming more expensive.

The crisis

The collapse of Lehman Brothers on 15 September 2008 was a tipping point for the Icelandic crisis. Without it, some argue that Iceland could conceivably have pulled through. After Lehman, credit lines were pulled. Glitnir, the third largest Icelandic bank, could not meet a €750 million payment on 15 October, so it sought funding from the Central Bank of Iceland.

As a result, central bank governor, David Oddsson, a former Icelandic prime minister, then made a decision, which many have considered political, to nationalise Glitnir on punitive terms. The central bank would inject €600 million into the bank and take a 75 per cent stake in it. Subsequently, Glitnir's share price fell sharply. In a 27 December 2008 paper, *The Icelandic Banking Collapse: A Story of Broken Promises*, Tryggvi Thor Herbertsson, professor of economics at Reykjavik University, noted that the majority of Glitnir's stock had been pledged in Kaupthing and Landsbanki. With the fall in Glitnir's stock prices stockholders were subject to margin calls that they could not meet, and the collateral became almost worthless. He noted that the situation with Glitnir was starting to affect the other banks, especially Landsbanki.

Landsbanki reimbursement issues

In October 2008, when Landsbanki collapsed, the UK Icesave internet accounts were valued at £4.5 billion. The Iceland deposit insurance scheme covered each deposit only up to €20,887. The UK Financial Services Compensation Scheme (FSCS), of which Landsbanki had chosen to be part, provided further coverage.

The immediate fear in the United Kingdom was whether depositors would get their money back. On 7 October, shortly after the event, Oddsson appeared on local television and told viewers, 'We will not pay for irresponsible debtors and ... not for bankers who have behaved irresponsibly.'

On the same day Arni Mathiesen, the Icelandic minister of finance, spoke on the telephone with Alistair Darling, the UK chancellor of the Exchequer. According to Mathiesen, nothing in this conversation had indicated that Iceland would not provide the required support of the Icesave accounts. A day later, however, Darling said, 'The Icelandic government, believe or not, have told me yesterday that they have no intention of honouring their obligations here.' Even if Iceland was to pay up, there were £800 million of retail deposits covered by neither the Icelandic scheme nor the FSCS top-up.

Darling, like Oddsson in his country, was a domestic politician playing to the gallery. He acted on his words. On 8 October 2008, the UK government froze the assets of Landsbanki and other Icelandic operations, including Kaupthing, using

the Anti-Terrorism, Crime and Security Act 2001. The Icelandic authorities said that the move branded their country as terrorists. In a subsequent 18 June 2009 speech at the Institute of International and European Affairs, a think-tank in Dublin, Geir Haarde, former prime minister of Iceland, said that the legislation used as a basis for the freezing order had been ‘controversial at the time because it was feared it could be used in non-terrorist situations like this one’ (Haarde, 2009).

Haarde said in his speech that the freezing order caused utter confusion among those trading with Iceland, and disrupted the payment system for transactions going in and out of the country for several days. He said that if there had been a reason for initiating such an action, and he did not think there was, the first step should have been to initiate urgent and formal talks between the two governments. He said that the action had led to bad blood.

According to the Financial Services Authority (FSA) in its *Financial Risk Outlook 2009*, the government concluded that the UK Landsbanki branch deposits should be protected to underpin confidence in the banking system, and with the FSCS, it met the initial costs for depositor protection.

Action against Kaupthing

On 8 October 2008 the FSA moved to take Kaupthing Singer & Friedlander (KSF), a UK subsidiary of Kaupthing, out of business after concluding it was in breach of liquidity regulations. The UK regulator prevented KSF from accepting further deposits, and its Edge Online deposit operation was forcibly sold to ING Direct, the UK retail savings division of the Dutch bank. According to Kaupthing’s creditors, this represented a technical default based on the parent company’s loan book. KSF was placed into administration on an application filed by the FSA.

Kaupthing subsequently collapsed, leaving a recent €500 million loan from the Central Bank of Iceland unpaid. The lender seized a Danish bank that Kaupthing had provided as collateral. The Icelandic government now had control of all the big three Icelandic banks.

Not all UK commentators were sympathetic. The ‘outrageous bullying behaviour’ of the UK government in freezing Icelandic assets (it invoked the 2001 Anti-Terrorism, Crime and Security Act, passed after the 11 September 2001 terrorist attacks in the United States to justify the freezing of the UK assets of Landsbanki and Kaupthing) probably precipitated Kaupthing’s collapse, according to Willem Buiters, professor of European political economy at the London School of Economics and Political Science, and his wife Anne Sibert, head of economics, maths and statistics at Birkbeck College (Buiters and Siebert, 2008).

Subsequently, the resolution committee of Kaupthing, representing its creditors, initiated legal proceedings against HM Treasury in relation to the FSA’s

actions taken against KSF. In September 2009 the matter was under judicial review. The Icelandic Government Information Centre had published a statement on its website declaring strong support for the legal proceedings, which it could back financially. The Icelandic authorities had considered similar action in respect of the UK's freezing of assets based on anti-terrorist legislation. On legal advice it had noted, however, such an action was unlikely to succeed because of the wide and discretionary powers given to the UK chancellor under the legislation.

Flaws in cross-border regulation

The events around Icelandic deposit accounts were part of an eventual systemic collapse of Iceland's banking system. They also exposed flaws in the European Economic Area (EEA) passporting regime. In a speech at the Turner Review conference, Adair Turner (2009b), chairman of the FSA, said that the failure of Landsbanki had shown that the present approach to the European market in retail banking was 'unsafe and untenable'.

The problem, as outlined in the FSA's *Financial Risk Outlook 2009*, was that Landsbanki's UK branch was not subject to full prudential supervision by the FSA. Under EEA rules banks can operate as branches in another country, and unlike with subsidiaries, it is the home country supervisor – in this case, Iceland's – that has responsibility for supervision of solvency and whole-bank liquidity. This is known as passporting. The host country supervisor – in this case the FSA – has only limited supervisory powers. This means that depositors in one country could be vulnerable to bank failure in another country.

The FSA has taken the position that bank branch passporting rights require review. The government has taken up the issue at European level. In November 2008 the UK chancellor of the Exchequer wrote to the European Commission with proposals to have safeguards in place if cross-border banks within the EEA should fail. The 2009 De Larosière report, commissioned by the European Commission, also focused on lessons to be learnt from Iceland's experience. According to the European Commission, the EEA passporting regime would come under scrutiny in a planned 2010 review of the Markets in Financial Instruments Directive.

The Financial Supervisory Authority (FME), as supervisor of the Icelandic banks, already accepts a measure of responsibility for the banking problems. In an August 2009 interview with Complinet, Gunnar Andersen, who had become director-general of the FME in April of that year, some six months after the collapse of the main banks, said it was untrue that the FME had not done checks and balances on the banking sector (Davidson, 2009e). He added that the FME could not, however, cope with the sector's high growth. 'We were understaffed, we had a 25 per cent staff turnover and, in one area, 100 per cent, and we were

under financed. We should have done more and dug deeper, but we didn't have the resources. There's blame to share and we accept some of it.' He said that the FME, with others, had not understood the systemic risk of banking activity in Iceland.

The banking crisis

The FME is part of the Icelandic authorities, which were, as a whole, woefully ill-equipped to deal with the runaway horse of the Icelandic banking system. How much they tried has come under scrutiny. Not unlike the United Kingdom and the United States, Iceland did not hesitate to reap the rewards of the high-risk lending strategies of its banks while the bonanza lasted.

As Buitter and Sibert pointed out in their 2008 CEPR paper, Iceland's business model, operating internationally in the financial markets with high leverage, was not compatible with its financial regime.

Kaarlo Jännäri in his *Report on Banking Regulation and Supervision in Iceland*, commissioned by the Icelandic government in line with its stand-by arrangement with the International Monetary Fund and published in March 2009, said that the first potentially wrong decisions came at the time of the Icelandic banks' privatisation. Jännäri, who has been director general of the Finnish Financial Supervision Authority, noted that in 2002, the government allowed Samson to have a *de facto* controlling interest of 45 per cent stake in Landsbanki, then the country's largest bank. He said that when Kaupthing and Glitnir were created, the FME could not limit concentration in these banks because of the legal precedent created by the 2002 decision.

In early 2007 the Icelandic authorities were openly concerned about the growth of the banking system, and said they would like the banks to become smaller. Market conditions had become difficult, making it hard for the banks to sell their assets, and the FME lacked the legal authority to intervene. According to the CEPR paper, by the end of the first quarter of 2008, the total assets of Glitnir, Landsbanki and Kaupthing were US\$176 billion, almost 11 times the country's gross domestic product.

From early 2008 the European Central Bank was becoming very concerned about the large amounts that the Icelandic banks had been borrowing from the system. The quality of collateral had come under scrutiny, with a significant part being claims against other Icelandic banks.

Economic issues had exacerbated the problems. The Central Bank of Iceland had pursued inflation targeting. If inflation is above target the central bank raises interest rates, but if inflation is below target, it reduces them. The strategy has sometimes worked well in some countries, including the United Kingdom, but it was inappropriate in Iceland.

A major factor in the failure was that most bank lending in Iceland has been either denominated in foreign currencies or index-linked to the local Consumer Price Index. This has meant that changes in short-term nominal interest rates are ineffective as a tool of monetary policy.

As an outcome, inflation in Iceland was above target during the crisis, which means that interest rates were set high, even exceeding 15 per cent. Local businesses and families reacted by borrowing in foreign currencies, which was cheaper, and currency speculators moved in. Foreign currency flowed into the economy, and the Icelandic króna exchange rate rose sharply, creating a mirage of prosperity and encouraging economic growth. The end result was a fast depreciation of the exchange rate, which critics say the Central Bank of Iceland should have anticipated.

Limits on bailout facilities

Iceland's foreign currency culture limited the government's ability to bail out Iceland. A central bank may only provide foreign currency loans to the extent it can exchange its domestic currency for foreign. In this case, the CEPR paper found that the Icelandic banking sector had sufficiently large foreign currency liabilities to mean the government could probably not provide adequate foreign currency deposit insurance or liquidity to replace short-term foreign currency liabilities. Many say that a way to address Iceland's main currency issues would be to apply for EU membership. This is under political debate in Iceland. The process of gaining membership is lengthy, but a successful result would leave the country with sound solvency procedures.

New and old banks

Emergency legislation in Iceland, passed on 5 October 2009, three days before the UK government froze the accounts of Icelandic banks, gave broad powers to the FME to take over banks that could not meet their obligations and to appoint resolution committees to replace boards of directors. Within three days the FME had taken the three largest banks out of business and split each into two entities: an old bank, run by a resolution committee, and a new bank, run by a new management team.

Domestic banking would continue uninterrupted through the new banks, which took over domestic deposits and some domestic assets, including impaired ones (non-performing and distressed loans). The new banks, named Islandsbanki, as the successor to Glitnir, New Kaupthing and New Landsbanki, are wholly owned by the state, which said it would inject US\$2 billion of capital into them.

The old banks have the purpose of dealing with foreign creditors and maximising value for them. They retain the assets that have not moved to the new banks and bonds issued by the new banks for assets they took over. International creditors are far from satisfied with the emergency legislation and the plan. The legislation put domestic depositors ahead of international creditors as claimants on the banks' assets, leaving a diminished pot of assets available to the latter group. In Landsbanki's case, €11 billion of retail deposits were transferred from the Landsbanki group's reach.

From the Icelandic authorities' perspective, this move was essential to prevent a run on the banks, and had some legal precedent. International creditors argued that it shifted the goalposts, changing the law retroactively, out of kilter with international standards.

In a 2009 survey by law firm Norton Rose (Gärdfors and Tirado, 2009), about 60 international creditors of Iceland, mainly large, mainstream European banks, said that in the main that the Icelandic authorities had lacked transparency and engagement in their dealings with them, including on asset valuation. As many as 95 per cent of respondents said that the Icelandic authorities did not respond properly to the country's crisis. There was a complete collapse in confidence in Iceland's institutions, with 91 per cent of respondents lacking faith in the government and 97 per cent lacking trust in the FME.

Towards resolution

IMF and bilateral loans

On 24 October 2008 the International Monetary Fund (IMF) announced a US\$2.1 billion package for Iceland. The IMF loan would fill about 42 per cent of the country's 2008–10 financing gap, with the remainder to be met by official bilateral creditors. The financing would support a programme, agreed by the Icelandic authorities, intended to stop the króna from further depreciation.

Iceland government debt repayments

The UK and Dutch governments lent together more than US\$5 billion to the Depositors' and Investors' Guarantee fund in Iceland to enable compensation of savers in Icesave accounts. It was these loan agreements that led to the United Kingdom's unfreezing of Landsbanki's assets on 15 June 2009.

Under the loan agreements, Iceland will repay an amount each year, limited by its GDP, which describes its level of economic output. In August 2009 Iceland's parliament passed legislation authorising the state guarantee by the

UK and Dutch governments. By September 2009 these two governments had not yet publicly agreed to the loan agreements, as amended by the Icelandic government, without which new bilateral loans from the Nordic countries would be unlikely, meaning the IMF programme as agreed would not be fully funded and could not be approved by the IMF board.

According to a Fitch Ratings 3 September report on Iceland (Rawkins and Riley, 2009), Iceland was not in any immediate need of IMF/bilateral funds, but a prolonged impasse over this issue ‘would greatly complicate IMF and bilateral relations, and damage prospects for EU accession’.

International creditors

International creditors are concerned that, following the emergency legislation, they could receive an inadequate amount from the Icelandic banks. The Norton Rose survey found that 93 per cent of respondents would consider taking legal action to secure a fairer settlement for international creditors.

How far they would get is unclear. Michael Hudson, economics professor and economics adviser to the Icelandic government, has stated publicly on the internet his view that if creditors take action that stifles the Icelandic economy with austerity and if current emigration from Iceland continues, there will be no growth in the country and creditors will not be paid.

Fraud investigations

In December 2008 the Icelandic parliament voted unanimously to establish a special investigation committee to examine the crisis and determine what could have gone wrong. The committee has been conducting its work on an ongoing basis. By separate legislation, Iceland’s parliament established an office of special prosecutor to look into and eventually prosecute anybody who had acted illegally in relation to the banking system’s collapse.

In the United Kingdom, the Serious Fraud Office has so far done only intelligence gathering on Icelandic banks, and by August 2009 had not yet decided whether to investigate.

Two of the recommendations

International cooperation

The Jännäri report recommends, among other actions, that Iceland should participate actively in international cooperation on financial regulation and supervision, in particular within the EEA and the European Union. This would

rebuild trust between Icelandic and foreign authorities, as well as being the best way for Iceland to try to participate in formulating regulations and practices within the European single market.

Banking regulation

In its Economic Survey of Iceland (2009b), the Organisation for Economic Co-operation and Development (OECD) said that to restrain the build-up of systemic risks in the future, macro-prudential supervision needs a legal basis to restrain bank behaviour, such as through countercyclical capital adequacy requirements. To implement this reform, the OECD said that it might be necessary to merge the Central Bank of Iceland, the macro-prudential supervisor, and the FME, the micro-prudential supervisor, or at least bring them under the same administrative umbrella as planned. This was broadly in line with a recommendation in the Jännäri report.

According to the OECD, Iceland's supervisors should not allow the banking sector to become so complex and large that they cannot effectively fulfil their supervisory duties. It said that the Icelandic authorities should review and improve the deposit guarantee system to protect the taxpayer from new large costs.

The OECD said that to eliminate uncertainties about the strength of the balance sheets of the new banks, the government should move low-quality domestic assets into an asset management company, which would dispose of them in time. The banks should be streamlined to make them profitable. The OECD said that these measures would help to prepare for full privatisation of the banks in the next few years and that, to facilitate privatisation, foreign direct investment into the Icelandic banks should be encouraged.

Conclusion

The Iceland crisis has shown up weaknesses in European passporting rules and in the level and frequency of cross-border regulatory liaisons. Depositors in the Icelandic banks seem to have been protected, although how far this would have happened if the UK government had not acted to freeze accounts is open to debate. The biggest financial loss from the Icelandic crisis might fall on international creditors, although the numbers have not yet been fully determined.

Islamic finance

Introduction

In this chapter, we shall look at the development of Islamic finance in the City of London. We shall assess its benefits and limitations, its growth prospects, and the impact of the 2007–10 financial crisis.

Overview

General

The academic work underlying modern Islamic finance started in the 1950s. Since the first fully fledged Islamic commercial bank was established in 1975, the industry has come far, with most of its growth in the 2000s. Islamic finance conforms to Islamic commercial jurisprudence, derived from the divine Islamic law known as *Shari'a*, the primary sources of which are *Qura'n*, the holy book of Muslims, and the tradition of Prophet Mohammad.

Under Islamic commercial jurisprudence, every transaction is deemed permissible unless the purpose or structure of financing involves a prohibited element. The purpose of financing should not be activities prohibited in Islam, such as consumption of alcohol or gambling.

Structurally, Islamic finance must avoid *riba* in all contracts and excessive *gharar* in commutative contracts. *Riba* is often translated as usury, but it is better to think of the meaning as including the lending of money for interest, and academics commonly explain the Quranic prohibition of *riba* on the basis that it is a contract, unfair to the borrower or the lender, or both. The meaning of *gharar* includes the trading of risk, and the concept has been applied to conventional insurance and derivatives.

Also prohibited is *maysir*, which means gambling or zero-sum games, and is often seen as an extreme *gharar*. Scholars disagree on the meanings of *riba* and *gharar*, but the concepts are fundamental to Islamic finance. Muslim jurist Ibn Taymiyya reportedly said that these two prohibitions could explain every distinction between contracts considered valid and invalid.

The broader social objective underlying *Shari'a* compliance, as often brought out in Islamic finance literature, is economic justice. Some Muslim academics have argued that lending money for interest results in concentration of wealth, diverting resources to those who are deemed most creditworthy, but may not have the best business ideas or entrepreneurial ability. They say that credit is diverted to governments, large corporations and rich individuals.

The argument continues that if, instead of a loan for interest, there was equity participation between contracting parties, in line with the principles of Islamic finance, capital providers would be more concerned with the feasibility of ventures, and resources would be deployed more productively. Another alternative to lending for interest is to trade or lease real assets, meaning that contracting parties remain active in the real economy and capital assumes the risk associated with asset ownership.

Some argue that the trading of risk unbundled from an asset diverts people from productive life into activities that may harm the trader and others. An example is the trading of credit default swaps ahead of the credit crunch. Islamic finance, in its legitimate form, prefers equity participation and risk sharing.

The City of London

Islamic finance matters to the City of London. According to IFSL Research, *Islamic Finance 2009* (McKenzie, 2009c), the United Kingdom is the leading centre for Islamic financial services and has US\$18 billion in reported assets. Tax and legislative changes in the United Kingdom have been designed to help Islamic finance develop.

Some international institutions have established 'Islamic windows' in the United Kingdom and elsewhere. Cynics say that this was a way to retain the substantial funds of Middle East investors after the 11 September 2001 terrorist attacks on the United States, when there was a perceived risk that some would withdraw their money on concerns about the mindset and activities they were ultimately financing.

Let us take a look at the sectors where Islamic finance is developing.

Sectors and products

Islamic finance mainly consists of banking, capital markets and *takaful*, or insurance, although there are some products outside these categories.

Banking

The prohibition on *riba* implies that money is not a commodity and that the principle of ‘money now for more money later’, which underlies conventional banking, is unacceptable. In Islamic finance, to earn a return, money must assume the risk associated with the ownership of an asset or the outcome of an enterprise, or both.

On this basis, an Islamic bank does not issue a monetary loan to buy an asset, but may buy the asset and sell it to the customer at a mark-up, based on a benchmark rate of return, typically the London Interbank Offered Rate. The customer will pay back the cost in instalments. Since this financing arrangement takes the form of a trade of an asset rather than a monetary loan, jurists have allowed it on legal and technical grounds, although the difference between the spot and credit price of the asset could be explained as implied interest. In principle, Islamic finance prefers joint ventures to credit sales and financial leases, but the latter dominate Islamic banking.

When an Islamic bank takes deposits, the rate of return should be linked to its investment decisions. The bank should give depositors a share of the profits or losses, with the agreement being on the distribution ratio. This is risk sharing, a core principle of Islamic finance and the one most often compromised.

According to *Islamic Banks and Financial Stability: An Empirical Analysis*, an International Monetary Fund (IMF) working paper (Cihák and Hesse, 2008), small Islamic banks tend to be financially stronger than large Islamic banks or small conventional banks, perhaps because it is more complex for the Islamic banks to adjust their credit monitoring systems as they become larger. However, large conventional banks are financially stronger than large Islamic banks.

In the United Kingdom, five fully *Shari’a* compliant banks have been established and there are 17 conventional banks that have set up windows in the United Kingdom to provide Islamic financial services.

National Savings & Investments conducted, at the request of HM Treasury, a review of the feasibility of offering *Shari’a*-compliant retail banking products to the UK market. In June 2008 the study published its conclusions that it would be premature for the government to offer such products at this stage (National Savings & Investments, 2008).

Capital markets

Sukuk (Islamic bonds)

Sukuk are debt instruments. *Sukuk* should be similar to securitisation based on the true sale of a pool of real assets, with payouts based solely on performance of the underlying assets. That, however, might not be the case; investors may rely on the credit rating of the obligor, with the asset playing a ceremonial role.

According to IFSL Research, *Islamic Finance 2009* (McKenzie, 2009c), global issuance of *Sukuk* rose from US\$1 billion in 2002 to US\$42 billion in 2007. At the end of 2008, there were 18 listings in London worth US\$10 billion.

In November 2008 the UK government said, following a review, that it would not offer value for money if it was to issue a *Shari'a*-compliant government bond, but that it would keep the situation under review.

Funds (equity, commodities, sukuk and so on)

Islamic equity funds avoid what they regard as sinful industries and companies with significant leverage, defined as more than a third of their market capitalisation or assets. There are also commodities and *sukuk* funds.

According to EurekaHedge estimates, there were globally 680 *Shari'a* compliant funds in 2008, up from 150 in 2000, including mutual and alternative funds, investment trusts, private equity, real estate and structured products.

Most Islamic funds are domiciled in the Gulf Co-operation Council (GCC) countries and Malaysia, but in 2008 several UK offerings were launched, including four exchange-traded funds listed on the London Stock Exchange, a fund of equity funds, and others.

Takaful

Conventional insurance is not permitted under *Shari'a* law, partly because it involves *gharar* (trading of risk) without any underlying asset. Islamic finance has its own form of insurance, which is known as *takaful*. This is based on the concept of *Ta'awuni*, which means mutual assistance, and is considered in compliance with *Shari'a* law. Instead of trading risk as in conventional insurance, *takaful* is a risk-sharing arrangement that allows pooling contributions to benefit all subscribers.

Unlike conventional insurance, a *takaful* operator is not allowed to invest in, for example, interest-earning investments such as government bonds, or in shares of companies involved in armaments, alcohol sales or gambling. Such restrictions could mean that *takaful* products are not competitively priced.

According to the IFSL (McKenzie, 2009c), the global market for *takaful* is at an early stage of its development. In 2007 its global premiums are estimated at US\$7.2 billion, up from US\$3.6 billion in 2004. Growth of *takaful* in the United Kingdom could help to develop the Islamic mortgage market, and the product could be attractive to non-Muslims, as well as to Muslims, for its ethical approach. Principle Insurance, authorised by the Financial Services Authority (FSA) in 2008, is the first *Shari'a*-compliant independent *takaful* company in the United Kingdom. HSBC Amanah has a home insurance offering.

There are concerns. FSA-authorised insurers must have a solvency margin, which represents the excess of assets over liabilities and provides a cushion against unexpected claims. The rules on admissibility of assets set limits on how much of an asset's value can be included in the calculation for determining the solvency margin. They are designed to encourage a sufficient spread of investments, and can cause a problem for *takaful* operators with their limited investment scope.

Takaful providers need reinsurance, as any insurers do, as a main part of their technical reserves. Currently *re-takaful*, which is Islamic reinsurance, is in short supply and *takaful* providers lay significant risk to conventional reinsurers. If *re-takaful* became significantly more available, scholars would become less amenable to allowing *takaful* providers to use conventional reinsurance.

Other financial products

The range of Islamic products is broadening. In the United Kingdom, in 2007 Merrill Lynch structured the first *Shari'a*-compliant credit default swap for a UK power company involving GCC investors. In 2008, Barclays Capital and *Shari'a* Capital Inc. of the United States launched the first Islamic fund of hedge funds. *Shari'a*-compliant public–private partnerships are under consideration.

Developing Islamic finance

Standard-setting bodies

Islamic finance relies on two main standard-setting bodies, the Bahrain-based Accounting and Auditing Organization for Islamic Financial Institutions and the Kuala Lumpur-based Islamic Financial Services Board (IFSB). The former focuses on accounting and *Shari'a* standards, and the latter works more on the regulatory and prudential side. For institutions offering Islamic services, the standards issued by these bodies are largely voluntary, but they have substantial influence.

Policing the industry

In the United Kingdom, the FSA regulates Islamic financial services. As a secular regulator, it does not concern itself with *Shari'a* compliance. Separately, Islamic institutions have their own *Shari'a* supervisory board, which aims to ensure that the business is run in compliance with *Shari'a* rules.

Adequate monitoring of *Shari'a* compliance is important. Some products, if in breach of *Shari'a* compliance rules, can adversely affect a firm's solvency by converting an asset to a liability on the balance sheet.

The FSA has noted that a shortage of suitable *Shari'a* scholars has meant individual scholars have commonly held positions on the supervisory boards of several Islamic firms, raising regulatory concerns about the ability of these boards to provide sufficiently rigorous oversight of products and services.

Government support

A HM Treasury paper in December 2008, *The Development of Islamic Finance in the UK: The government's perspective*, had a double purpose. The first aim was to raise awareness about Islamic finance and its recent development in the United Kingdom. The second was to highlight the unique challenges faced by the sector, identifying areas where good progress has been made and providing the government's perspective on where further barriers to development lie.

The paper identified barriers to the development of Islamic finance, including taxation, where the government wished to ensure Islamic finance would be taxed no more harshly nor more lightly than equivalent structures. New legislation in 2009 was to provide relief from stamp duty land tax for alternative finance investment bonds.

Another barrier identified was regulation, which in financial services had been created to deal with conventional products, and another was standardisation. Other barriers included general awareness and skills to keep up with the market's growth.

Education

UK institutions are at the forefront of providing Islamic finance qualifications for the global industry, which is helping with the skills shortage. For example, the Chartered Institute of Management Accountants has a certificate in Islamic finance, and the Association of International Accountants certifies a Diploma in Islamic Accounting and Compliance. The Securities and Investment Institute (SII) offers an Islamic Finance Qualification.

The Islamic Finance Council UK has developed a pioneering 'Scholar Professional Development Programme' in conjunction with the SII. The course's aim is to teach conventional finance to *Shari'a* scholars worldwide.

'Islamic finance may have been a mystery in the past, but thanks to the various learning opportunities – academic qualifications, professional qualifications, publications, trainings, lectures, seminars, etc – available to today's professional, it no longer should be one,' says Usman Hayat, director of Islamic finance and ESG investing at the CFA Institute, which offers a number of educational podcasts on Islamic finance.

The missing global Shari'a standards

The lack of global *Shari'a* standards is a factor holding back the Islamic finance industry's development. Although a product might be deemed *Shari'a* compliant by the *Shari'a* board of one institution, the board of another might not agree. Differences exist both within and across jurisdictions, and are mostly based around definitions of *riba* and *gharar*. The differences across Malaysia and the Middle East, for instance, are well known.

Global standards would be more relevant for debt and derivatives than for equity or equity-like investments, where real assets are involved and contracting parties genuinely share the risk.

In late 2007 a notable *Shari'a* scholar criticised some *sukuk* structures for lack of *Shari'a* compliance, and this shook the industry. In 2009, in another setback to the industry on *Shari'a* grounds, the prestigious Islamic Fiqh Academy of the Organization of Islamic Conferences dismissed *tawarruq*, a form of commodity *murabaha*, as a stratagem to circumvent the prohibition of *riba*, although this contract is frequently used by Islamic banks. In commodity *murabaha* a bank buys a commodity for a client, and the client pays the bank back the cost of the commodity as well as a bank charge or profit rate at a later date. In *tawarruq*, the contract can also be used to secure cash when the client sells the commodity on again, effectively buying money from the bank for the cost of the profit rate. Critics of commodity *murabaha* say that the deal is a near-instant paper transaction with little relation to the underlying commodity, so breaking the rule that profit must be gained from physical assets.

Both of these rulings have longer-term implications for Islamic finance.

The financial crisis and after

According to IFSL Research, *Islamic Finance 2009* (McKenzie, 2009c), the Islamic finance industry felt the influence of the credit crunch and economic downturn in 2008, with a decline in *sukuk* issuance and in the value of equity funds. Islamic banks were less affected than many conventional banks because they had not been exposed to toxic assets or dependent on wholesale funds.

The financial crisis has led to a surge of interest in such simple and conservative financing. In March 2009 *Osservatore Romano*, the Vatican's official newspaper, published an article (Napoleoni and Segre, 2009) that argued that banks should consider the rules of Islamic finance to restore client confidence.

In an April 2009 Complinet webcast, Mohammed Amin, a tax partner at PricewaterhouseCoopers, said that many believed that if more firms had used the *Shari'a*-type principle, the credit crunch and ensuing economic crisis might

not have happened. He said that the sub-prime mortgages offered to people in the United States would not have been permitted under *Shari'a* principles. Offering taster deals to people at very low rates only to raise them a couple of years later to a level they had no hope of affording would have been unethical under Islamic finance.

In a 22 July 2009 blog, ft.com/maverecon, Willem Buiter, professor of European political economy at the European Institute, London School of Economics and Political Science, further developed the case for Islamic financial services in the 2009 economic climate (Buiter, 2009b). He said that if too much debt and too little capital was part of the problem in the crisis, then the conversion of debt into equity was part of the solution. He called for the application of Islamic finance principles, and in particular a strong preference for risk-sharing arrangements and a rejection of *riba*. He excluded, however, the 'sham *Shari'a* compliant instruments that flooded the market in the decade before the crisis'.

The big debate – form versus substance

The big ongoing debate in Islamic finance is how far the products are really Islamic. Critics routinely point to the gap between the theory and practice. They say that the modern Islamic finance has put religious form above substance, and it is merely replicating products and services offered in conventional finance. Most of the debate is centred on the lack of risk–reward sharing where, through alleged legal devices, money earns a return while it manages to avoid taking the risk associated with the ownership of an asset or the outcome of an enterprise. Critics often trace the problem to the conflict of interest inherent in *Shari'a* compliance, where scholars issuing religious rulings are paid by the entities that benefit from these rulings. It is a conflict not dissimilar to that facing credit rating agencies.

Sympathisers with Islamic finance say that the industry is growing within the conventional finance space and faces significant legal, fiscal and economic challenges, a small but not insignificant factor being that interest charged on monetary loans is tax deductible, but dividends on equity, a form of risk–reward sharing, are not. The sympathisers argue that the industry should have more time to move towards genuine risk–reward sharing between contracting parties.

The debate around form versus substance has commercial implications. If Muslims, the primary target market, do not see Islamic finance as authentically Islamic, and if non-Muslims see no economic advantage in *Shari'a*-compliant products, the young Islamic finance industry will not, in the long term, compete with conventional finance.

The future

Islamic finance remains small, reportedly less than 1 per cent of the conventional finance industry in size, but it has huge potential. Many believe it is most likely to achieve further market penetration if it expands its range of genuinely Islamic products. The United Kingdom is the leading Western country involved.

Ethics and integrity

Introduction

The arguably reckless trading of sub-prime debt, the big bonus culture in banks driving short-term profit-taking, the failure to handle conflicts of interest in credit rating agencies and other lapses of standards all contributed to the 2007–10 financial crisis. As a result, there has been a new focus on ethics and integrity.

In the area of securities and banking, the Chartered Institute for Securities & Investment (CISI) leads the way in promoting ethics. It has a code of conduct, and it is pushing for greater inclusion of ethics in industry examinations at a higher level, where it believes there is more scope for case studies or scenarios, requiring some careful thought from the examination candidate. The SII promotes ethics in its monthly magazine, in case study books, through e-learning and through an annual ethics lecture or debate.

In the insurance industry, the Chartered Insurance Institute (CII) is taking a lead in establishing ethical standards in the insurance industry. To fine-tune the role of ethics in company behaviour, the CII has run a review of ethics in parallel with revisions to its code of ethics, and both came under substantial discussion in 2009.

Conceptual uncertainty

There are disagreements about what ethics and integrity entail. In the academic community, integrity remains a disputed concept. In a 2009 public lecture in London, Professor John Cottingham, a moral philosopher at Reading University, said that integrity was integration of the psyche. He noted that some moral philosophers, such as Bernard Williams and Harry Frankfurt, took the view that this was all that is required for virtue. ‘Their approach cuts integrity free from

the moral orientation it needs. I take the view that values cannot be a matter only of subjective validity.'

In financial services, the disagreements take a more practical bent. The CSII has noted that, a few years ago ethics had religious connotations, which put some people off, so it decided to use the term 'integrity' in the title of a book on the subject (Securities & Investment Institute, 2009), as in a sense synonymous with ethics.

Giles Cuthbert, director of professional standards at the Chartered Institute of Bankers in Scotland, said in a seminar on conflicts of interest and ethics, run by the Financial Industry Regulatory Authority and Complyport, that he saw no reason, contrary to the popular conception, for a link between professionalism and ethics.

Overlap with regulation

The Financial Services Authority (FSA) has become involved, for the first time, in the introduction of a code of ethics in name, but not in sentiment, in connection with the Retail Distribution Review. The regulator has set out its thinking on a code of ethics to be implemented by a professional standards board, as an outcome of the review. It envisages the code will expand on the existing standards that a consumer expects of an adviser, but will not move the goalposts.

The FSA's case is that its principles encourage ethical behaviour, and that it expects people to behave ethically to meet its requirements. In May 2009, the FSA banned David Redmond, who had been a trader at investment bank Morgan Stanley, from performing any function in relation to any regulated activity. Redmond had taken an extended lunch break and drunk alcohol over lunch before he built up a short position in breach of Morgan Stanley's policies and procedures, and then concealed it overnight, exposing the firm to the risk of a significant loss. The FSA rules did not specify that a person could not drink, but they must have the ability to do their job, as an FSA spokesperson said at the time. The FSA rules are about not individual behaviour, but outcomes.

According to Jonathan Herbst, partner at Norton Rose, codes of ethics potentially vary from regulation in two ways: where matters fall outside regulated activity and where codes of ethics amplify regulatory principles (Davidson, 2009f). An example of activity that may fall outside the scope of regulation is unregulated activity within a regulated bank, to which the FSA's principles would extend only in relation to prudential concerns.

There is a question whether ethical behaviour is something the FSA can enforce, which is arguably why the regulator cannot operate only on principles, and relies on rules as well. According to David Thomson, director of policy and public affairs at the CII, the FSA regulates firms, but does not focus so much on individual practitioner behaviour (Davidson, 2009f). Professional bodies have

that responsibility, but financial services have not always had that ethical starting point, and the CII is trying to instil it. He said that conflicts of interest are covered by ethics codes, but not entirely by regulation.

In the Securities & Investment Institute (now CISI) annual lecture in September 2009, a debate between practitioners on ‘What does the City need to do to restore trust in the market?’ Guy Jubb (Jubb, Booth & Board, 2009), head of corporate governance at Standard Life Investments, said that the City needed an emphasis on personal responsibility and a return to morality, not rafts of new regulation, to restore confidence. He cited President Obama, who had talked about the need to restore a ‘willingness’ to take responsibility.

Professor Philip Booth, editorial and programme director at the Institute of Economic Affairs, said that the ‘ferocious detail of financial regulation’ disoriented the senior management of financial companies, causing managers to focus more on the regulators above them than on the customers below (Jubb, Booth & Board, 2009). He said that compliance and the adoption of a ‘box-ticking mentality’ prevented firms from perceiving the need for ethics and customer satisfaction, and that the more detailed the regulation, the more firms were tempted to develop complex products to side-step regulation. He said that many products, such as zero-dividend preference shares and mortgage endowments, that had been subject to scandal in recent years, had been developed purely to avoid the vagaries of the tax system.

Booth called for a more rational and limited framework of financial regulation and a return to having virtuous people in financial markets. He suggested that regulation and government guarantees had removed the commercial advantage from ethical behaviour.

Professor John Board, professor of finance and director of the International Capital Market Association at Reading University, said that it was important to distinguish confidence and trust (Jubb, Booth & Board, 2009). Confidence could be obtained by having a structure, rules and by people conforming to those rules, but trust was difficult, and it was about a belief that fair play would result. Board said that the behaviour of firms and employees had to change, but there was no quick solution. Those involved would have to work hard and long, and conscientiously try to rebuild confidence and trust.

Putting ethics into practice

Obviously, large firms can afford to spend more getting the ethics message across, including through face-to-face technology. There is some feeling that bankers may take ethics more seriously now that the FSA is involved in an

ethics code. There is also a feeling that ethics is down to the individual and that to enforce it is impossible.

The Walker Review of corporate governance of the UK banking industry, under consultation in 2009, does not refer explicitly to a code of ethics. It is clear, however, that ethical behaviour is at the heart of many of the recommendations. For instance, the review recommends that non-executive directors should be prepared to challenge the executive if they think it necessary, which would require having the courage to stand up and be counted – perhaps sometimes to make themselves unpopular in the boardroom.

At a 2009 CII ethics seminar, Philippa Foster Back at the Institute of Business Ethics noted that 90–95 per cent of FTSE-100 companies had codes of ethics, and yet failures continued. She queried whether this was because the codes had been written legally, in unapproachable language, and from the organisation's point of view rather than from that of individuals (Foster Back, 2009).

According to Roger Steare, professor of organisational ethics at Cass Business School, there is no proof that codes or rules change behaviour. He noted in conversation with Complanet that Enron's code of ethics was fine and that even banks that flouted ethics such as Lehman Brothers had a code of conduct. His case was that financial institutions needed to have conversations with customers, staff and others about shared moral values and what would be the outcomes, and that this is about more than training (Davidson, 2009f).

In July 2009, a report, *Vision for the Insurance Industry in 2020* (HM Treasury, 2009b), set out the proposals of a high-level working group co-chaired by chancellor Alistair Darling and Andrew Moss, group chief executive of Aviva. According to the report, the insurance industry should act more as a partner with government in helping consumers provide for their future and protect themselves against life's risks. There would be a virtuous circle, starting by improving financial education and raising awareness of the need for personal savings and ending with getting more money into the UK insurance industry. The industry needed the right regulatory and legal framework to enable it to 'price according to risk factors'.

Sceptics queried how easily the initiative would succeed. Consumer organisation, *Which?* told *Complanet* that the industry that created payment protection insurance mis-selling would need to do a lot to demonstrate that it should be central to a government strategy on ethics and consumer protection.

The way forward

Focus Consulting Group in the United States has found that trust is lacking in insurance as well as in banking, and that trust is highly correlated to the rise and

fall of the financial markets. In a 2009 presentation hosted by the CFA Society of the UK in London, Jim Ware, founder of Focus, said that Focus Consulting had worked closely with Edelman Group, which found that trust in the US banking industry declined 35 points from 71 to 36 per cent in a year between 2007 and 2008, and trust in the US insurance industry slipped 21 points from 50 to 29 per cent. He said that the same distrust of banks and insurance companies extended into other countries, including the United Kingdom (Davidson, 2009g).

How much the new talk about ethics and integrity in the City will be a solution remains uncertain. Clearly the City is not going to change its culture overnight, and the United Kingdom is not going to create disincentives for short-term greed, in the area of bonuses, for instance, unless it is part of internationally coordinated activity, failing which London could quickly become anti-competitive as staff and businesses desert it for more lucrative regions of the world.

Cynics say that ethics is unenforceable and all that carries weight is regulation. They say that parties promoting ethics are often making money out of it, including through peddling new industry courses. There is an element of truth in their points, but nobody could accuse the industry trade bodies of insincerity in promoting ethical standards, even if the outcomes are not, in retrospect, as effective as one may have liked them to be.

Final word

We live in times of unprecedented uncertainty. As at November 2009, with this book going to press, the UK economy was still far from a full recovery. The Bank of England's aggressive £200 billion stimulus already pumped into the economy through quantitative easing had reduced borrowing costs for banks and some large companies, but this appeared to be coming to an end. As the opposition Conservative Party leader David Cameron publicly said, the practice of 'printing money' would 'soon have to stop' because, in the end, it would lead to inflation.

In addition to quantitative easing, the government has been responsible for a massive fiscal stimulus, with public spending and avoidance of tax increases. In the long run, the country needs to deal with public debt, but more evidence for recovery must come first.

The experts are not agreed on the timescale for recovery. Forecasts vary, and are based on changing circumstances, which means they cannot be taken literally.

In the real economy, public confidence is not yet back. Unemployment has soared as consumers have stayed frugal in their spending. Part of the problem is that banks are loath to lend on any scale. Mervyn King, governor of the Bank of England, said in November 2009 that the bank system was reducing its leverage from extraordinary high levels, and until that had happened, the supply of credit to households and businesses would be impeded.

In some parts of the City the mood was more optimistic. By November 2009, shares had risen 50 per cent since March, partly retrieving earlier heavy losses but also reflecting some genuine recovery, and property prices had risen. Gold had reached a record high, above US\$1,000 an ounce, and the oil price had recovered some of its earlier decline to reach almost US\$80 a barrel.

How much this was all an asset price bubble, temporary in nature, had become the subject of intense debate. At least one central bank argued that it

was an ‘irrational exuberance’ type bubble, and this was less dangerous than a ‘credit’ bubble because it did not have a similar capacity to fuel a credit boom of a kind that preceded the crisis. Critics are casting doubt on whether central banks can detect a bubble at all, however, let alone say which kind it is.

Even if we are in an ‘irrational exuberance’ bubble, there is a case that this leads to tax cuts and lower interest rates which can, in turn, lead to a credit bubble. Critics say that this is what happened in the ‘irrational exuberance’ bubble before March 2000, when investors rushed to buy dot.com stocks, many of which had no significant track record or profits, sending share prices soaring. In late 2001 the US Federal Reserve started a series of interest rate cuts, which reduced the Federal Funds rate to 1 per cent in 2004, and the consensus is that this helped to fuel the current crisis.

Nouriel Roubini, the US economist, is bearish about what he sees as the present asset price bubble. He says that the next financial disaster could arise from the US dollar carry trade, where speculators borrow cheap dollars which they immediately invest in assets that pay higher returns than the interest on the loans. By way of precedent, there is a view that the unwinding of the yen carry trade in late 2008 played a major part in spreading the US crisis abroad.

In so far as the music has started playing again in banking, some banks are starting to dance. Some have paid high bonuses and there are even new forms of securitisation. How far the banks will change their behaviour as a result of the crisis depends at least partly on legislation. As the third edition of this book went to press, the Financial Services Bill was about to be published. The bill will give new responsibility to the Financial Services Authority to stop bankers receiving extra bonuses, and to cancel pay agreements that encouraged too much risk taking. The state is to take over bankers’ contracts.

There is some public pressure on policymakers to exact some kind of penalty from banks for the excesses that led to the crisis. The International Monetary Fund is looking at proposals for taxing financial transactions or alternative options. At EU level, the competition commissioner Neelie Kroes has forced RBS and Lloyds TSB to break up their businesses over a four-year period, which some commentators have considered is partly punishment for creating moral hazard.

Financial services regulation, monetary policy and every other aspect of helping recovery are hot political issues, and recovery of the economy depends hugely on government support. In its recovery momentum, the United Kingdom is not insulated from the United States or the European Union, or indeed the world. The unresolved problem of systemic risk is global. The G-20 leaders said in a 7 November 2009 communiqué that the recovery was uneven and that the group would maintain support for the recovery until it was assured.

Once recovery comes in full, some of the old problems may be forgotten. The City, like society at large, repeats its mistakes in substance, and this is a lesson of history. There are always the good times, when everyone forgets caution and takes risks, followed by a sobering-up, when everyone suffers from the past excesses. Bull markets are followed by bear markets. Soft insurance markets are followed by hard.

As financial services consumers, we perhaps cannot just blame the City for the problems of the credit crisis. Were we not greedy enough to take out mortgages we could not afford and to buy shares assuming they would keep going up in value? One takeaway from this book is that we must get streetwise about investment. This is not about interpreting the alphabet soup of CDOs, CDO squared, CLOs, CDS and the rest of it. It is rather about common sense.

This book gives you enough of an overview of the City to follow your newspaper, television and financial websites in a way that will, I hope, enhance your investment decisions as well as your broad understanding. The websites listed in Appendix 1 and the books in Appendix 2 will extend your understanding further on an ongoing basis. This can take you a long way and put you on a level with the professionals. Good luck!

Appendix 1:

Useful websites

Here is a list of some financial websites that have proved useful to me. Use it as a starting point for your own requirements.

Accounting and corporate governance

ACCA, the global body for professional accountants, www.accaglobal.com
Financial Reporting Council, www.frc.org.uk
International Accounting Standards Board, www.iasb.co.uk
PricewaterhouseCoopers, www.pwc.com

Banking and building societies

British Bankers' Association, www.bba.org.uk
The Building Societies Association, www.bsa.org.uk
London Investment Banking Association, www.liba.org.uk

Bonds

Debt Management Office (gilts), www.dmo.gov.uk
International Capital Market Association, www.icma-group.org

Collective investments and similar

Alternative Investment Management Association, www.aima.org
The Association of Investment Companies, www.theaic.co.uk
Investment Management Association, www.investmentuk.org
Morningstar.co.uk, www.morningstar.co.uk
Standard & Poor's – funds website, www.funds-sp.com
Trustnet – a particularly good funds website, www.trustnet.com

Complaints and compensation

Department for Business Innovation & Skills, www.berr.gov.uk

Financial Ombudsman Service, www.financial-ombudsman.co.uk

Financial Services Authority – UK financial services regulator, www.fsa.gov.uk

Financial Services Compensation Scheme, www.fscs.org.uk

Office of Fair Trading, www.oft.gov.uk

Press Complaints Commission, www.pcc.org.uk

Credit rating agencies

A M Best, www.ambest.co.uk

Fitch Ratings, www.fitchratings.com

Moody's, www.moodys.com

Standard & Poor's, www.standardandpoors.com

Derivatives and commodities

Eurex, www.eurexchange.com

Futures and Options Association, www.foa.co.uk

Ice Futures, www.theice.com

London Metal Exchange, www.lme.co.uk

NYSE Euronext, www.nyse.com

World Gold Council, www.gold.org

Economy

Bank of England, www.bankofengland.co.uk

European Central Bank (English site), www.ecb.int

HM Treasury, www.hm-treasury.gov.uk

National Statistics, www.statistics.gov.uk

Organisation for Economic Co-operation and Development, www.oecd.org

Samuel Brittan, economic commentator for the *Financial Times*, www.samuelbrittan.co.uk

David Smith, economics editor of the *Sunday Times*, www.economicsuk.com

Ethics

Chartered Institute for Securities & Investment, www.secinst.co.uk

Roger Steare Consulting, www.rogersteare.com

Factoring and leasing

Asset Based Finance Association, www.abfa.org.uk

Finance and Leasing Association, www.fla.org.uk

Foreign exchange

ICAP, www.icap.com (register with the ICAP Knowledge Centre for courses)

Iceland

Central Bank of Iceland, www.sedlabanki.is

Financial Supervisory Authority – Iceland (FME), www.fme.is

Icelandic.org – Icelandic Government’s Information & Services, www.iceland.org

Insurance

Association of British Insurers, www.abi.org.uk

British Insurance Brokers’ Association, www.biba.org.uk

Chartered Insurance Institute, www.cii.co.uk

International Underwriting Association of London, www.iaa.co.uk

Lloyd’s, www.lloyds.com

Investor relations

Buchanan Communications, www.buchanan.uk.com

Investor Relations Society, www.ir-soc.org.uk

Islamic Finance

Institute of Islamic Banking and Insurance, www.islamic-banking.com

Law enforcement and similar

City of London Police, www.cityoflondon.police.uk

Serious Fraud Office, www.sfo.gov.uk

Serious Organised Crime Agency, www.soca.gov.uk

Money laundering and fraud

Egmont Group, www.egmontgroup.org

Financial Action Task Force, www.fatf-gafi.org

Insurance Fraud Investigators Group, www.ific.org

International Association of Insurance Fraud Agencies, www.iaifa.org

Joint Money Laundering Steering Group, www.jmlsg.org.uk

Nick Kochan – a journalist’s site with some interesting articles, www.nickkochan.com

Proximal Consulting – run by Peter Lilley, www.proximalconsulting.com

Transparency International, www.transparency.org

Money markets

Wholesale Market Brokers' Association, www.wmba.org.uk

News, data and research

Advfn, www.advfn.com

AWD Moneyextra, www.moneyextra.com

BBC, www.bbc.co.uk

Bloomberg News, www.bloomberg.com

Breakingviews, www.breakingviews.com

Citywire, www.citywire.co.uk

Corporation of London, www.cityoflondon.gov.uk

Digital Look, www.digitallook.com

Economist, www.economist.com

FT.com, www.ft.com

Guardian, www.guardian.co.uk

Hemscott, www.hemscott.com

Independent, www.independent.co.uk

Interactive Investor, www.iii.co.uk

International Financial Services London, www.ifsl.org.uk

Investors Chronicle, www.investorschronicle.co.uk

Mergermarket, www.mergermarket.com

MoneyAM, www.moneyam.com

Motley Fool UK, www.fool.co.uk

Reuters, www.reuters.co.uk

Telegraph, www.telegraph.co.uk

Times Online, www.timesonline.co.uk

Pensions

Association of Consulting Actuaries, www.aca.org.uk

Financial Assistance Scheme, www.dwp.gov.uk/fas

Financial Services Authority pension website, www.moneymadeclear.fsa.gov.uk/pensions

National Association of Pension Funds, www.napf.co.uk

Pension Protection Fund, www.pensionprotectionfund.co.uk

Pension Sorter, www.pensionsorter.co.uk

Post-trade services

DTCC, www.dtcc.com

Euroclear UK & Ireland, www.euroclear.co.uk

LCH.Clearnet Limited, www.lchclearnet.com

SIX x-clear - the central counterparty service, www.ccp.sisclear.com

Private investors

Association of Private Client Investment Managers and Stockbrokers, www.apcims.co.uk
UKSA – UK Shareholders’ Association, www.uksa.org.uk

Regulation in the United Kingdom and Europe

Committee of European Banking Supervisors, www.c-ebs.org
Committee of European Insurance and Occupational Pensions Supervisors, www.ceiops.org
Committee of European Securities Regulators, www.cesr-eu.org
Competition Commission, www.mmc.gov.uk
Complinet.com, www.complinet.com
European Commission, <http://ec.europa.eu>
Federation of European Securities Exchanges, www.fese.be
Financial Services Authority, www.fsa.gov.uk

Global regulation and related initiatives

Financial Stability Board, www.financialstabilityboard.org
G-20, www.g20.org
International Association of Insurance Supervisors, www.iaisweb.org
International Organization of Securities Commissions, www.iosco.org

Risk management

Association of Insurance and Risk Managers, www.airmic.com
Federation of European Risk Management Associations, www.ferma.eu

Shipping

Baltic Exchange, www.balticexchange.com
Consultants on Maritime Transport, <http://maritimeconsultants.org/index.html>
International Chamber of Shipping, www.mariscec.org
International Maritime Organization, www.imo.org
International Union of Marine Insurance, www.iumi.com

Stock exchanges, capital raising and equity trading

British Venture Capital Association, www.bvca.co.uk
Chi-X, www.chi-x.com
Deutsche Börse, <http://deutsche-boerse.com>
Equiduct, www.easdaq.be
London Stock Exchange, www.londonstockexchange.com
NASDAQ, www.nasdaq.com
NYSE Liffe, www.liffe.com

Pink Sheets, www.pinksheets.com

Plus Markets Group, www.plusmarketsgroup.com

Technical analysis

Building wealth through shares – the website of Colin Nicholson, technical analyst and teacher, www.bwts.com.au

International Federation of Technical Analysts, www.ifta.org

Society of Technical Analysts, www.sta-uk.org



Appendix 2: Further reading

Invest your time

The cost of buying books is negligible when weighed against the information they can provide and the ideas they can spark. The real investment is your time.

Many of the books recommended in this chapter provide an overview rather than specialist detail. Some also focus on aspects of the 2007–10 financial crisis, which has been a major learning experience for the markets. If you have learnt something from this book, you will certainly appreciate some of the recommended reading, and find it useful.

You can buy books online or by telephone, often at an excellent discount, through Global-investor.com (www.global-investor.com), which is my favourite bookshop because it has a high level of personal service, delivers reliably and has some interesting features on its site. Otherwise, try Amazon (www.amazon.co.uk), which publishes useful book reviews and offers some seriously reduced prices, particularly through resellers.

General guides to the City

Financial markets are global. If you want to get to grips with the broader picture, read *The Times: How the global financial markets really work*, by Alexander Davidson (Kogan Page, 2009). This complements the book you are reading. You may also find useful *The Times: How to understand the financial pages*, by Alexander Davidson (Kogan Page, 2nd edn, 2008). For an overview read the classic *An Introduction to Global Financial Markets* by Stephen Valdez (Palgrave, 5th edn, 2006).

For a book explaining how the City works in easy language I recommend *All you Need to Know About the City: Who does what and why in London's financial markets, 2009/10*, by Christopher Stoakes (Longtail, rev edn, 2007). This book is presented in bite-size chunks and in an easy-to-read style.

Stock market

The Complete Guide to Online Stock Market Investing: The Definitive 20-day guide, by Alexander Davidson (Kogan Page, 2006) is worth reading if you want to become a successful stock market investor. It is a substantially updated version of my earlier bestseller, and it tells you all that you need to know about investing online.

Shares Made Simple: A beginner's guide to the stock market, by Rodney Hobson (Harriman House, 2007) is an excellent guide to the stock market. It explains the basics in a clear, no-nonsense way.

Among beginners' guides, I also recommend *Investing in Stocks and Shares: A step-by-step guide to making money on the stock market* by John White (How to Books, 2007).

The Naked Trader by Robbie Burns (Harriman House, 2nd edn, 2007) is a tongue-in-cheek beginner's guide to trading written from experience. This is an irreverent young person's book, and it contains home truths, with the author's own new rules alongside the old. Read it to have a crack at gaining financial independence – through investing or anything else.

Taming the Lion: 100 secret strategies for investing, by Richard Farleigh (Harriman House, 2005) reveals the author's personal and highly successful investing methods. The semi-autobiographical approach helps to bring the text to life.

The Disciplined Trader by Mark Douglas (New York Institute of Finance, 1990) shows you how the territory represented by stock markets is, unlike the world we know, uncaring, unforgiving and ruthless. This classic book changed the way I looked at the stock market, and it is a must-read, the appropriately dark content and original perspectives more than compensating for a wordy writing style.

As a supplement to other reading, *Trading Secrets: 20 hard and fast rules to help you beat the stock market* by Simon Thompson (Financial Times/Prentice Hall 2008), shows you some interesting ways as an investor to narrow the odds in your favour.

A brilliant book from a successful investor is *The Next Big Investment Boom: Learn the secrets of investing from a master and how to profit from commodities* by Mark Shipman (Kogan Page, 2006). The author explains his own proven methods.

For a realistic fictionalised account of how analysts in banks bluff, use people and sell ideas to clients, as well as for a thoroughly entertaining read, do not miss *Cityboy: Beer and loathing in the square mile*, by Geraint Anderson (Headline, 2009).

The Little Book That Beats the Market by Joel Greenblatt (John Wiley, 2005) is a wonderfully easy-to-read book about a method of value investing, packed with common sense.

A more detailed read on value investing is Benjamin Graham's classic *The Intelligent Investor* (Harper Collins, 2003).

For some useful ideas on growth investing, read *The Zulu Principle* by Jim Slater, which is easy-to-read but above beginner's level. It is a modern classic, and Harriman House Publishing has published a 2008 revised edition.

An older classic stock market primer, and unmissable, is Peter Lynch's *One Up on Wall Street* (Simon & Schuster, 2nd rev edn, 2000).

The Only Three Questions That Count: Investing by knowing what others don't, by Ken Fisher with Jennifer Chou and Lara Hoffmans (John Wiley, 2006) makes interesting reading. In this book, market pundit, columnist and author Ken Fisher provides an intellectual framework through which to make investment decisions. He stresses that asset allocation matters more than stock selection.

If you are interested in technical analysis as part of a growth investing strategy, you should read *How to Make Money in Stocks, 3rd edition: A winning system in good times or bad*, by William O'Neil (McGraw-Hill, 2002).

Technical analysis has a controversial status in the City, but enough of a following in some markets to influence price movements. To find out more, read *Technical Analysis of the Financial Markets: A comprehensive guide to trading methods and applications*, by John Murphy (New York Institute of Finance, 2nd rev edn, 1998). This is probably the best overall book on technical analysis, and is the core text of the professional courses run by the Society of Technical Analysts.

For a lighter approach, try *Investors Chronicle Guide to Charting: An analysis for the intelligent investor*, by Alistair Blair (Financial Times/Prentice Hall, 2002). This is a cynic's introduction, and is entertaining as well as providing a good overview.

Forecasting Financial Markets: The psychology of successful investing by Tony Plummer (4th edn, Kogan Page, 2003) explains the mass psychology behind stock market rises and falls from a technical perspective. It is a fascinating book.

Marber on Markets: How to make money from charts by Brian Marber (Harriman House, 2007) is a world-class technical analyst's take on his craft, written in a lively style with some fascinating and irreverent ideas.

Derivatives

Derivatives have come into prominence as a result of the role of credit default swaps in the 2007–10 global credit crisis. To understand what happened, read *Fool's Gold* by Gillian Tett (Little, Brown, 2009). The author, a prominent *Financial Times* journalist, tells the story from the perspective of bankers at JP Morgan, which invented the credit default swap.

To understand how derivatives can go wrong, read *Rogue Trader* by Nick Leeson (Time Warner Paperbacks, 1997). It is the autobiography of the trader who brought down Barings Bank. The event helped to spur regulatory changes in the City. The events described are historical, but the author offers universal insights into how derivatives traders work.

Traders Guns and Money: Knowns and unknowns in the dazzling world of derivatives by Satyajit Das (Financial Times/Prentice Hall, 2006), is a fascinating and informed fictionalised biography that works as a primer on derivatives. It is not an easy read.

When Genius Failed: The rise and fall of Long Term Capital Management by Roger Lowenstein (Fourth Estate, new edn, 2002) gives a fascinating account of a major hedge fund disaster.

If you are a retail investor wanting to trade derivatives, it is worth reading *The Investors Toolbox: How to use spread betting, CFDs, options, warrants and trackers to boost returns and reduce risk*, by Peter Temple (Harriman House, 2nd edn, 2007). The author is a former equities analyst and a prolific investment writer. If you are a beginner to derivatives trading, you are in safe hands.

If you want to learn about commodities derivatives, I recommend *Hot Commodities* by Jim Rogers (John Wiley, 2007). This is an easy-to-read text from a master investor, and is unashamedly bullish about commodity markets. Rogers has strong opinions on which commodities will do well, and provides a reasoned case. The author is a renowned globetrotter and the book is international in scope.

Post trading

Back-office operations are usually invisible to investors, but play a key role in keeping capitals market functioning. In *Plumbers and Visionaries: Securities settlement and Europe's financial market* by Peter Norman (John Wiley, 2007) the author, a former *Financial Times* journalist, walks the reader through from the freewheeling days of the eurobond market in the 1960s to the highly regulated and efficient multi-trillion pound business that securities settlement is today.

Economics and the credit crunch

The modern economist who best explains things in layman's terms is in my view Paul Krugman. Read his *The Return of Depression Economics and the Crisis of 2008* (Allen Lane, 2008). See also his lectures and interviews on YouTube and on the London School of Economics website.

For a particularly clear explanation of the financial crisis of 2007–10, including an attack on efficient markets theory as the foundation for our financial markets and central banks, and with a pro-Keynesian stance, read *The Origin of Financial Crises: Central banks, credit bubbles and the efficient market fallacy* by George Cooper (Harriman House, 2008).

For a book reviving the economist Keynes's insight into animal spirits, read *Animal Spirits: How human psychology drives the economy, and why it matters for global capitalism* by George Akerlof and Robert Shiller (Princeton University Press, 2009).

Two Trillion Dollar Meltdown: Easy money, high rollers and the great credit crash by Charles R Morris (Public Affairs, 2009) provides an informative and analytical overview of the financial crisis. It is largely US-focused and delves into areas that usually remain hidden, such as the true leverage levels of hedge funds and why this is more precarious than it is sometimes represented.

Another excellent book on the financial crisis is *Meltdown: The end of the age of greed* by Paul Mason (Verso, 2009).

Free Lunch by David Smith (Profile, 2003) is a lightweight but thought-provoking introduction to economics, penned by the economics editor of the *Sunday Times*.

To find out why modelling does not work, and how it causes crises, read *Fooled by Randomness: The hidden role of chance in life and in the markets* by Nassim Taleb (Penguin, 2007). The author is an independent thinker with a lively, irreverent style.

When Bubbles Burst: Surviving the financial fallout, by John Calverley (Nicholas Brealey, 2009) provides powerful insight into asset price bubbles – how they start, work and collapse, and how to survive them. The author is head of research, North America, at Standard Chartered Bank.

Corporate finance

The Penguin Guide to Finance by Hugo Dixon (Penguin, 2000) is a journalistic primer on corporate finance. It is no textbook, but it provides a good overview and some back-of-the-envelope calculation methods, and – almost unheard-of – makes the subject entertaining.

The Real Cost of Capital by Tim Ogier, John Rugman and Lucinda Spicer (Financial Times/Prentice Hall, 2004) is a useful introduction to measuring cost of capital. The authors, a team of three at PricewaterhouseCoopers, explain the capital asset pricing model (CAPM), but warn of its deficiencies. The guidance on estimating the international weighted average cost of capital – using mainly versions of CAPM – breaks new ground, and there is an assault on DCF forecasts, for which cost of capital is used as a key interest rate. The book explores real options valuation as an alternative.

Risk management

Dealing with Financial Risk: A guide to financial risk management by David Shirreff (Economist Books, 2004) is a journalistic trot through the basics of financial risk management. It is a cynical, sometimes entertaining, book and provides a valuable introduction.

Money laundering and fraud

Boiler Room (DVD directed by Ben Younger, 2000) A film but too good to exclude from this list because it provides an authentic view of how a boiler room selling dud share works.

Dirty Dealing: The untold truth about global money laundering, international crime and terrorism by Peter Lilley (Kogan Page, 3rd edn, 2006) offers a lucid and lively introduction to how money laundering works, and how regulators and legislators are trying to combat it.

The Washing Machine by Nick Kochan (Gerald Duckworth, 2006) is an entertaining guide to how money laundering works today. The book is in some respects more cynical than Lilley's. The author, an investigative journalist, gets under the skin of the anti-money-laundering bravado, demonstrating how ineffectual much of it is.

You will find a lively account of the Madoff fraud in *Madoff: The man who stole \$65 billion* by Erin Arvedlund (Penguin, 2009).



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