the review

PROVIDING INSIGHT AND ANALYSIS FOR FINANCIAL SERVICES PROFESSIONALS

CISI.ORG/REVIEW

MAR 2023

DEMAND FOR CHEAPER FUNDS DRIVES GROWTH IN INDICES

CORPORATE INSOLVENCIES SET TO RISE

THE PROs AND CONs OF BECOMING AN EXPERT WITNESS

Are we ready to step up?

TRACY VEGRO, CHIEF EXECUTIVE OF THE CISI, MAPS OUT THE ROAD AHEAD

CISI
CHARTERED INSTITUTE FOR SECURITIES & INVESTMENT

welcome

“Read about our new CEO’s vision and leadership style in our profile piece from page 24”

“Are we ready to step up?”

Tracy Vegro OBE asked the above question when she joined as chief executive of the Institute in September 2022, speaking of opportunities for the CISI to expand wider society’s understanding of the benefits of financial services, boosting financial literacy and investment advice. Read about her vision, leadership style, thoughts on diversity and inclusion, and more, in our profile piece (pp.24–27).

Shortly after Tracy spoke of the need to raise standards of knowledge, two expert contributors to *The Review*, Con Keating and Iain Clacher, submitted a piece analysing disruption to the UK gilt market, saying that pension schemes adopted liability-driven investment (LDI) because of a “misconceived accounting standard” (*cisi.org/ldi*). This point is picked up by a recent House of Lords committee report, covered in our *Review of Financial Markets* (*RoFM*) section (p.67), which states that LDI is a “solution to an artificial problem created by accounting standards”. Read Keating and Clacher’s detailed roundup of lessons learned (pp.61–66).

Our special report for this edition looks at indices – why we have them, the companies behind them, and how the new generation of indices in the passive world compares with more traditional ones (pp.16–23). It shows their staggering growth over the past decade or so, with, for example, their percentage of total share of the US funds market growing from 20% in 2011 to 43% in 2021.

Looking at a different kind of growth, our piece on pension freedoms says that, according to the Bank of England, assets in UK defined contribution (DC) schemes are expected to double from £500bn in 2021 to £1tn in 2030 (pp.37–40), and asks if DC funds, in the context of imminent regulatory change, are prepared to take on greater risk for greater reward.

We also look at risks arising from weaknesses in global corporate reporting (pp.34–36), which countries have more robust systems (Ukraine) than others (UK), and why.

Other highlights in this edition include our feature on the growth of corporate insolvencies post pandemic (pp.29–33), guidance and case studies for those thinking of becoming an expert witness (pp.41–44), our Grey Matters ethical dilemma about whether to accept a bonus which appears to come from a manager’s own pocket (pp.46–47), and Andrew Davis’s column about the impact of rising base rates on the global investment landscape (p.70).

As ever, please get in touch with any comments or suggestions.

Jane Playdon
***Review* editor, CISI**
jane.playdon@cisi.org

***Review* editor, Chartered Institute for Securities & Investment**
Jane Playdon
20 Fenchurch Street, London EC3M 3BY
T: +44 20 7645 0648
jane.playdon@cisi.org

Editorial Panel

Claire Perryman, Chartered MCSI
State Street
Chair

Helen Anderson, Chartered Marketer FCIM MCIPR
Chartered Institute for Securities & Investment

Dr Emma Black, Chartered MCSI
Cascade Cash Management

Michael Cole-Fontayn MCSI
Chartered Institute for Securities & Investment

Scott Dobbie FCSI(Hon)
Deutsche Bank

Felicity Hooper MCSI
Investec Wealth & Investment

Amy Lazenby, Chartered FCSI
Close Brothers

Julius Lipner MCSI
Plutus Wealth Management

George Littlejohn MCSI
Chartered Institute for Securities & Investment

Robert Lockie CFP™ Chartered FCSI
Bloomsbury Wealth

David Madgwick, Chartered MCSI
Charles Stanley

Elizabeth Martine, Chartered FCSI
Close Brothers

Tsitsi Mutiti, Chartered FCSI
Charles Stanley

Tomas Owen-Jones CFP™ Chartered FCSI (Financial Planning)
Rathbone Investment Management

Helen Packard
Financial Conduct Authority

Frank Reardon, Chartered FCSI
JM Finn

Nigel Sydenham, Chartered FCSI
CCL Academy

Janet Walford OBE

Wardour contacts

Editor
Brian Gorman

Online editor
Fred Heritage

Senior art director
Steven Gibbon

Group account director
David Poulton

Production manager
Jack Morgan

Agency Founder
Martin MacConnol

Cover Photography
Charlie Surbey

Published on behalf of the Chartered Institute for Securities & Investment by Wardour, 2nd Floor, Kean House, 6 Kean Street, London WC2B 4AS

T: +44 20 7010 0999

Fax: +44 20 7010 0900

wardour.co.uk

ISSN: 1357-7069

© The Chartered Institute for Securities & Investment (CISI). All rights reserved. Reproduction in whole or part prohibited without prior permission of the CISI. The CISI and Wardour accept no responsibility for the views expressed by contributors to *The Review*; or for unsolicited manuscripts, photographs or illustrations; or for errors in articles or advertisements in *The Review*. The views expressed in *The Review* are not necessarily those held by the CISI or its members.

CFPTM, CERTIFIED FINANCIAL PLANNER™ and the CFP Logo are certification marks owned outside the US by Financial Planning Standards Board Ltd.

The Chartered Institute for Securities & Investment is the marks licensing authority for the CFP™ marks in the United Kingdom, through agreement with FPSB.

contents

membership news and views

10

6 CISI news
Updates from our international network of offices; branch news

9 Guest column
Stephen Shields, director at ACCA, on 'accounting for a better world'

10 People
Samar Yanni, head of CISI Membership and Professional Standards, talks to *Lora Benson* about some recent initiatives

11 Honorary Fellows
Lora Benson talks to Philippa Foster-Back CBE OBE FCSI(Hon), who was awarded an honorary CISI Fellowship in 2021

12 Events and quiz
Upcoming events for CISI members

14 First person
Anthony Hilton FCSI(Hon) on treating gloomy economic forecasts with caution

global insights

16

Special report:
16 Demand for cheaper funds drives growth in share indices
Bradley Gerrard sets out a rapid growth in the number of indices tracking shares

24

24 Ready to step up
Len Williams talks to Tracy Vegro OBE, the CISI's new chief executive, about her vision and priorities for the institute and the challenges ahead

29 Corporate insolvency threat
Peter Taylor-Whiffen looks at a combination of factors that could prompt a rise in the number of corporate insolvencies

34 Weaknesses in global corporate reporting
Bradley Gerrard finds that knowing who really owns what is an important step in the battle against financial crime

37 Pension freedoms risk and reward
Peter Taylor-Whiffen asks whether defined contribution pension schemes will take the opportunity to invest in riskier and less liquid assets

41 Being an expert witness
Laura Dew looks at the advantages and drawbacks of becoming an expert witness, including generous remuneration and potential reputational damage

37

professional development

46 Grey matters: Transfer authorised
When Ray receives an unexpected bonus of £500, he is in a dilemma as something is not quite right

48 Continuing professional development
A selection of our CPD content highlights

50 Ask the experts
Bharat Bhushan of KPMG and Jonathan Lister Parsons of PensionBee set out what is required at times of digital transformation

46

70

education

54 Regulatory update
Robbie Constance and *Carys Thompson* at DWF Law highlight key regulatory changes in sustainable finance, including how the CISI is helping to drive the agenda

58 Review of financial markets
News on the latest developments

70 Last word
Andrew Davis looks at the effects of rising interest rates

CISI.ORG

ONLINE CONTENT ACCESSIBLE THROUGH OUR MYCISI APP

100110
011001

Watch

WHAT DOES ETHICS AND INTEGRITY MEAN TO YOU?
Ian Peters MBE, director at the Institute of Business Ethics, talks about what it means to him and the importance of doing the right thing in the public interest.

cisi.org/ian-peters-ethics

MOST READ

Financial use cases of NFTs
cisi.org/nfts

Grey matters ethical dilemma: Transfer authorised
cisi.org/transfer-authorised

How to climb the career ladder
cisi.org/climb-ladder

New micromodule

DIVERSITY, EQUITY AND INCLUSION

CPD: 7 minutes
This micromodule consists of one video and covers several aspects concerning diversity, equity and inclusion.

cisi.org/micro-dei

To read more, visit *cisi.org/review*

Read

BANKER, CHAIR, LIVERYMAN … AMBULANCE DRIVER
CISI chair Michael Cole-Fontayn MCSI and his wife Angela drove to Ukraine to deliver an ambulance and much-needed supplies to the Kharkiv and Przemysl Project.

cisi.org/KHARPP

Our new Learning Platform is an all-in-one system giving access to all CISI CPD offerings within MyCISI.

VISIT *CISI.ORG* TO GAIN ACCESS TO ALL THIS GREAT CONTENT AND MORE

INTRODUCING MYCISI REWARDS FOR ALL YOUR PERSONAL MEMBERSHIP BENEFITS

Save up to 50% at popular high street brands and get up to 12% cashback on everyday shopping with our new reward platform within MyCISI. Enter competitions to win prizes and access the numerous wellbeing benefits and support tools on offer. Use our Quickstart tool to get started, register your details, set your shopping preferences and start saving.

Did you know 1 in 6 workers will experience depression, anxiety or problems relating to stress?

Our mental health portal offers resources and methods to consciously incorporate wellbeing in your office.

Visit our Mental Health Portal

cisi.org/startaconversation

End the Stigma, Start a Conversation

AROUND THE GLOBE

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

UK

Chief executive officer: Tracy Vegro OBE

On Thursday 6 October we held our annual Financial Planning Conference at the Grade 1 listed Merseyside Maritime Museum, Royal Albert Dock in Liverpool. Over 20 expert presenters gave 17 sessions across 3 content streams to over 200 delegates from around the world.

The conference culminated in the Financial Planning Awards, a black-tie gala held at Liverpool's iconic neoclassical Grade I listed St George's Hall. We celebrated award winners in several categories, including Accredited Financial Planning Firm of the Year (won by Berry & Oak); CERTIFIED FINANCIAL PLANNER™ Professional of the Year (David Hearne CFP™ Chartered FCSI (Financial Planning)), Financial Planning Partners; and Financial Planning Future Leader Award (James Beck CFP™ MCSI, Fiscal Engineers).

See the full list at cisi.org/fpawards2022
Book for the 2023 Financial Planning Conference at cisi.org/financialplanning23

NIGERIA

Assistant director, global business development: Helena Wilson, Chartered MCSI

The CISI warmly welcomes Ijeoma Onwu MCSI, general manager, audit, Johngift Consulting (pictured left), who has been appointed as the new president of our National Advisory Council (NAC); Obinna Okafor MCSI, CEO, Vicosbin Consult (middle), as our new first vice president; and Abiodun Adebimpe MCSI, head, custody services, Rand Merchant Bank (right), as the second vice president.

We thank them for their commitment to the Council thus far and wish them well in their new roles. We would also like to thank outgoing president Bola Ajomale for his inspiration and leadership in steering our community of professionals and NAC in Nigeria to this point. More details on these new postholders will follow on CISI news shortly.

CISI'S GLOBAL WEALTH SUMMIT SERIES

In November 2022 we held our second Global Wealth Summit for Africa, London, the Middle East, and China.

Some of the world's leading experts in the areas of wealth management and financial services headlined the series, which featured keynote sessions by leading figures, including Jackie Mau, managing director, head of global private banking at HSBC China, Ruth Handcock, chief executive officer, Octopus Investments, and Kathure Githinji-Nyamu, managing director, NCBA Investment Bank.

These were followed by live, virtual panel debates in each location, hosted by senior representatives, with financial services experts discussing the issues raised from a local perspective.

View the keynote speakers and the summits at cisi.org/cisitv

22%

of financial services firms have no measures in place to support staff going through menopause

CISI global menopause survey, cisi.org/menopause

SPAIN AND LATIN AMERICA

Regional head Iberia & LATAM: Rosa Mateus

Jesús Mardomingo (pictured), managing partner of Dentons' banking and finance department in Spain, is our new National Advisory Council (NAC) president in the region. Our NACs help local members develop professionally and enhance awareness of the Institute.

Jesús has more than 30 years' experience in corporate finance and consulting for administrations, credit institutions, insurance and investment companies. He was involved in the restructuring of the Spanish financial sector, the creation of the Sareb, the conversion of savings banks into foundations, and the digital transformation of the sector, serving as a lawyer for the first online banks in Spain, such as Uno-e and Inversis.

Before joining the firm, he worked as a lawyer in the legal department of BBVA.

cisi.org/nac-spain

CYPRUS

Assistant director, global business development: Helena Wilson, Chartered MCSI

On 5 September 2022, we announced a partnership with the European Institute of Management and Finance (EIMF) to provide training and support to local finance professionals and aspiring individuals.

EIMF, as our exclusive physical Accredited Training Partner in Cyprus, will provide a range of CISI certifications, including pathways in risk and compliance, capital markets and corporate finance, operations, and wealth management. It also hopes to develop relationships with other professional bodies on the island to enhance awareness of financial services as a career.

Marios Siathas, EIMF chief executive and member of the CISI Cyprus National Advisory Board, said that they will "focus on boosting CISI's already sterling reputation on the island, growing the range of educational opportunities available to local professionals, and providing even more value to Cypriot members".

cisi.org/eimf

PAKISTAN

Assistant director, global business development: Helena Wilson, Chartered MCSI

We have partnered with the University of Pakistan, which will offer training for a range of CISI qualifications. We have also signed an agreement with the Institute of Cost and Management Accountants of Pakistan (ICMA Pakistan) and are pleased to offer its members a route into CISI membership. Associate members will be able to join the CISI at the Associate member level and use the designatory letters ACSI, and Fellow members will be able to use the designatory letters MCSI.

More recently we have also signed an agreement with the Pakistan Stock Exchange and the Institute of Financial Markets of Pakistan (IFMP) to bring two new certifications to the market. The certifications will bring together the best of the CISI and the IFMP and cover securities and wealth management.

The CISI has also launched a Professional Assessment covering best practices in anti-money laundering and counter-terrorism financing, and local legislation, giving firms and individuals the opportunity to demonstrate their commitment to compliance in this area.

cisi.org/pakistan-aml

New presidents announced

YOUNG PROFESSIONALS' COMMITTEE

In January 2023, Luke Hornsby ACSI, senior consultant within the wealth and asset management risk and regulatory advisory practice at EY, took over the role from Emma Dobson MCSI, senior compliance manager at Santander.

Luke supports EY's wealth and asset management clients in their regulatory obligations within the UK, identifying and understanding their business and conduct risks, and implementing change to meet ever-evolving regulatory requirements.

He recently achieved the CISI level 6 Diploma in Investment Compliance and holds the CISI level 4 Investment Advice Diploma and level 3 Investment Operations Certificate. He also has a bachelor's degree in mathematics from the University of Greenwich.

Luke thanks Emma Dobson for laying "excellent foundations to build upon" and he hopes to move "forward the valuable work our committee does in providing young professionals with access to career development opportunities, mentoring, networking, support, and technical expertise".

cisi.org/luke-hornsby

See an interview with Luke on our YouTube channel at cisi.org/lukeYPN

CISI MANCHESTER BRANCH

In November 2022, Tricia Lucey ACSI, business and compliance manager at Luna Investment Management, took over the role from Rebecca Jones MCSI, compliance officer at BNY Mellon.

Tricia has recently completed a master's degree in management and leadership and is studying for the CISI level 4 Investment Advice Diploma.

She thanks Rebecca Jones "for her fantastic efforts over the previous years" and is looking "forward to the various CPD, social, and Young Professionals' Network events ahead, as well as hopefully expanding our educational programme to the benefit of a diverse range of students".

cisi.org/tricia-lucey

CISI GUERNSEY BRANCH

In October 2022, Ben Snook, Chartered MCSI, associate director at MJ Hudson Fund Services, took over the role from Christopher Jehan, Chartered FCSI, managing director at Midshore Consulting.

Ben has more than 18 years' experience working with various fund structures, including hedge funds, private equity, traditional mutual funds, and debt instruments. Prior to MJ Hudson, Ben was part of the team that structured and launched the first authorised Guernsey cryptocurrency fund.

He is chair of the Guernsey Investment and Funds Association – Technical & Innovation Committee.

Ben thanks Christopher Jehan "for his inspiration and leadership" and aims to increase CISI membership, "sharing the benefits of becoming active and involved".

cisi.org/ben-snook

ACCOUNTING FOR A BETTER WORLD

Everyone has a role to play in changing business for the better, says **Stephen Shields**, director, partnerships and recognition, at the Association of Chartered Certified Accountants (ACCA)

We can all make a difference to the world in our own lives, and our communities and organisations. What that change looks like, what it amounts to, will differ for everyone, because individuals and businesses are all different.

For us at ACCA, the way we seek change is summarised in an initiative that we call Accounting for a Better World – which helps us tell a powerful story of how the accountancy profession benefits societies and economies, and how it responds to the many challenges facing the world today.

This important initiative says so much about how our members play their part in building a better, more sustainable planet for all.

Perfect storm

In an age of upheaval, it's more important that professionals – such as ACCA members and readers of this journal – position themselves at the heart of issues such as sustainability, inclusion, ethics, and the increasing desire of individuals and societies around the world to change life for the better in the face of the Covid-19 pandemic, climate change, supply chain issues, uncertainty, and conflict.

Our agenda for action sets out seven priorities:

- Advancing standards and regulations
- Building resilient economies
- Developing the talent of tomorrow
- Driving sustainable business
- Strengthening ethics and trust
- Supporting entrepreneurial growth
- Transforming the public sector

A perfect storm of challenges has sent the issue of sustainable business in particular rocketing up the corporate agenda, and it's the biggest source of both risk and opportunity for all of us.

Grain of society

The drive for sustainability means that investors increasingly look at activities which bring dividends greater than a financial return when they are considering how to use capital. More and more, investors seek a commitment to sustainability, placing a premium on long-term stability rather than the instant gratification of a quick dollar. And, of course, there are increasing risks for investors who don't take this wider view.

> **“We measure success across years and decades rather than just financial quarters”**

This is good news for professional accountants, because we measure success across years and decades rather than just financial quarters, and are increasingly doing so against a whole set of indices – including social value, public wellbeing, and protecting the environment – looking at how all of these things impact the finances and risks of an organisation.

Just a few years ago, the idea of business placing the public good and impact on society at the top of its agenda would have been unthinkable. Economic orthodoxy was about maximising profit and the dash for growth. No longer. Any business with ambitions to survive through to the middle of the century and beyond must adopt a new way of keeping score – a new way of measuring value that goes beyond the numbers in the profit and loss columns. It's the only way they can limit the risk that they will be abandoned and left for dead by investors, consumers, and potential employees.

This marks a sea change in the way business is carried out, and this is the way the grain of society runs now. That much became clear at the COP26 (Conference of the Parties) summit in Glasgow in 2021, when a day of debate was devoted to the urgent necessity for businesses to realise that big investors will only commit capital if they are confident their return will be sustainable, long-term, and will minimise the risk of climate change, public antipathy, and damage to society.

Expensive mistake

No less a figure than Mark Carney, UN Special Envoy for Climate Action and Finance and ex-Bank of England governor, laid it on the line for businesses that relegate the risk of climate change in particular, saying, “Companies that have plans in place to reduce the emissions will find the capital – those who don't won't.”

In these days of doubt, we all need to play our part in accounting for a better world. It's an expensive mistake if we don't, in more ways than one. ●

Meet Samar Yanni, assistant director and head of CISI Membership & Professional Standards

SAMAR MANAGES FOUR TEAMS ACROSS THE CISI BUSINESS AREAS OF MEMBERSHIP, EVENTS, PROFESSIONAL STANDARDS, INTEGRITY, AND ETHICS.
BY **LORA BENSON** MCIPR, CISI HEAD OF MEDIA

Since joining the CISI in 2021, Samar Yanni has led on several key CISI initiatives, including the establishment of our Future Foundation, our Mentoring Scheme, and the launch of our Chartered Firm™ status.

Samar is well placed to do this, having experienced membership of the CISI as part of the continuing professional development requirements of a previous role as vice president, marketing manager at Gatehouse Bank, UK in 2017. And her talent for languages means she can communicate with members in English, French, Italian, and Arabic.

She applied for the position because of the CISI's "excellent global reputation in setting high standards", she says.

What are your highlights and achievements over the past year?
One of the team's main achievements is the launch of the designation Chartered Fellow (Financial Planning), which we are very proud of, as Chartership is perceived as the pinnacle of professionalism. We have also launched CISI Chartered firms. This has been in the making for a while, and we are delighted to finally be able to offer this designation to firms that meet the criteria.

The establishment of the CISI Future Foundation, a charity with the aim of improving financial literacy skills and the experience and outcomes of financial learning, through the provision of grants, is another highlight.

So, too, is strengthening our hybrid events, offering our members flexibility to join either in person or virtually. For example, over 1,000 members from 50 countries attended our 2022 Annual Integrity Event online, with just under 200 joining in person.

But for me, leading the development of our Mentoring Scheme, in response to member requests, is a highlight because I am passionate about empowering young people through coaching and mentoring. It was great to see an impressive uptake as soon as the scheme was launched.

Have you had personal experience of being mentored or mentoring someone?
I loved supporting young people when I lectured at universities, and I have mentored junior colleagues and taken on interns in the past, which I found very rewarding. What a feeling when you contribute, even if slightly, to someone else's learning, performance, or professional development!

> **"I am passionate about empowering young people"**

I have also been a mentee and, even though this didn't follow a formal structure at the time, I found it so helpful. The ability to look at situations from someone else's point of view is an eye-opener and allows you to find alternative ways to doing things or solving problems.

Any further developments that members should know about?
MyCISI Rewards, which launched in January 2023, replaces our member discount platform with one that offers a wider range of discounts and benefits as well as a wellness section.

We have also launched a campaign highlighting the importance of the CISI Code of Conduct and the changes made to it in 2021.

We are specifically looking at our offer for our younger members and those at the beginning of their career, or changing career. This includes our Young Professionals' Network (*cisi.org/ypn*). We are exploring ways to support this community even further.

Briefly, where have you worked and what did you do before joining CISI?
I worked for the Insolvency Practitioners Association, a regulator and professional membership body, as head of external affairs and member services. Before that, I worked at Gatehouse Bank, and prior to Gatehouse I was a consultant in marketing, branding, and presentation for about 16 years. Consulting gave me the opportunity to work for some very well-established financial services institutions and international advertising agencies.

With the flexibility offered by consulting, I also lectured part-time during the same period at different universities in the UK. These included Central Saint Martins – University of the Arts London, Syracuse University London, and HULT International Business School London.

Is there anyone either in your professional or personal life, over time, who has inspired you in some way? If so, who and why?
Thinking back at the different people who inspired me throughout my life, they all have dedication and inner strength, and keep going to reach their goals, no matter the difficulties they face. In that respect, my sister is probably my biggest inspiration. ●

An ethical expedition

PHILIPPA FOSTER-BACK CBE OBE FCSI(HON) WAS AWARDED A CISI HONORARY FELLOWSHIP IN SEPTEMBER 2021 FOR HER OUTSTANDING POSITIVE CONTRIBUTION TO THE FINANCIAL SERVICES SECTOR. BY **LORA BENSON** MCIPR, CISI HEAD OF MEDIA

Philippa has received several notable commendations over the course of her career, including an OBE in 2006 for services to the Ministry of Defence (MoD), a CBE in 2014 for services to the UK Antarctic Heritage, and multiple honorary fellowships.

As chair of the UK-Antarctic Place-Names Committee from 2009 to date, Philippa oversees the process of recommending to the government names for features in the British Overseas Territory in Antarctica. "There are rules as to the actual name assigned," she says. "A feature's shape or size will determine whether it is a peak or a mount, a ridge or a range. It is the equivalent of giving an honorific in the UK Honours system."

Philippa's connection to the Antarctic runs deep: her grandfather, Frank Debenham, was the first Professor of Geography at Cambridge and was a geologist on Captain Scott's last expedition to the South Pole in 1910–13. He introduced Philippa to geography, which she studied at University College London. She has always found it fascinating "as it is the study of interconnectedness of life on the planet, covering physical, human, and economic aspects of life through time".

From treasury to defence

Between the early 1980s and 2000, Philippa was group treasurer with UK firm Bowater and then the EMI Group. She joined Bowater to set up a US Commercial Paper programme for the company to finance its US subsidiaries. "It was interesting working in treasury, where one had access to visit the businesses in the group to understand how their business models, and hence their cashflows, worked."

Philippa's boss at Bowater was Geoffrey Jones, a founder of the Association of Corporate Treasurers (ACT). He encouraged her to join the education committee, which she subsequently chaired, leading the project to devise the ACT's part 1 examination syllabus.

She recalls that it was uncommon for women to work at a senior level in corporate treasury. "This was a reflection of the City at the time. Of course this has all changed and as treasury is more established as a profession, bankers and accountants see the attraction of a more business-orientated finance career. It is open to all, and the ACT is doing much to promote diversity too."

> "Financial services provides many opportunities to find a niche and succeed"

Philippa was invited to join the MoD in 1994 because of her treasury and finance experience. Her time as a non-executive director on the Defence Board and chair of the Defence Audit Committee until 2007 was "fascinating – meeting inspirational, brave people and learning how defence and security operates".

Ethical evolution

In early 2000, she joined the Institute of Business Ethics (IBE) as director, stepping down in 2020, coinciding with her time on the CISI Integrity & Ethics Committee: "Over the past 20 years, ethics and integrity have been recognised as a fundamental of doing business in the right way. Good training, particularly that done in a more subtle way, such as learning through the discussion of case studies, as in the CISI Grey Matters stories, is excellent. "There were many who inspired me during this time, particularly my colleague at the IBE Simon Webley. Receiving the CISI Honorary Fellowship in 2021 was a great honour which came out of the blue. I have greatly enjoyed working with CISI and made some good friendships too."

Some business sectors have made good progress in the past 20 years in the area of ethics, including, says Philippa, some high-profile firms considered 'difficult', such as oil and gas, defence and tobacco. These firms "made the earliest progress in embedding business ethics into their operations," she says, whereas "financial services has been slower in part with its ethics journey because it didn't necessarily look beyond the first tier of a company it was financing, but now the sector looks at the work the company does and what the finance is being used for."

Tips for new entrants to the sector

Philippa has held several senior leadership positions in her business career: "As the workplace changes, becoming more diverse, leadership is changing too and becoming more 'softer' edged than 30 or 40 years ago when it was a more patriarchal society."

She advises young people aspiring to a financial services career to "join a professional body, get qualified and enjoy the camaraderie of like-minded professionals. Getting involved will help build a career. Financial services is a large and varied sector so there are lots of opportunities to find one's niche and succeed." ●

Read the full article and Philippa's career summary CV at *cisi.org/ethical-expedition*

Events preview

We offer many opportunities to help you meet your requirements for continuing professional development (CPD). Below are just some of the highlights of the Institute's CPD events programme, but for comprehensive details and to book, please download the MyCISI app or visit *cisi.org* and click on the 'Events' section. Please note that dates listed below are subject to change.

LIVE WEBINARS

THU 30 MAR	Using good governance against bad practices: the role of professionals in the UK, Cyprus, and beyond
TUE 25 APR	Lifetime pension annuities
THU 4 MAY	Wills, trusts, and the great unknown surrounding business relief
THU 11 MAY	Integrity at work
THU 18 MAY	Paraplanner conference

IN-PERSON EVENTS

THU 23 MAR	Young Professionals' Network London
THU 20 APR	Cotswolds branch annual dinner
THU 20 APR	East Midlands & Lincoln annual dinner
THU 18 MAY	Liverpool, Chester & North Wales branch annual dinner
FRI 9 JUN	Guernsey branch annual dinner
TUE 13 JUN	Futureproofing financial services
THU 15 JUN	Northern Ireland branch annual dinner
FRI 29 SEP	Jersey branch annual dinner
3–4 OCT	Financial Planning Conference, Surrey

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

QUICK QUIZ

The Review's quick quiz features questions from CISI Professional Refresher, an online learning tool. The answers are on page 45.

The FTSE4Good UK Index is similar to which index?

A FTSE All-Share
B FTSE 100
C FTSE 250
D FTSE Small Cap

Which type of unfunded pension scheme does not facilitate access to pension freedoms?

A Defined benefit
B Defined contribution
C Final salary
D Public service

Which of the following is a reason why a company might have a rights issue?

A To extend voting obligations
B To raise money
C To increase the share price
D To reduce the share price

Which of the following processes best describes the term 'net zero'?

A Removing CO_2 from the atmosphere
B Offsetting CO_2 emissions via other projects, such as tree planting
C Reducing all greenhouse gas emissions, not just CO_2
D There is no single definition

If you or your firm would like to find out more, visit *cisi.org/refresher* or contact the CISI on +44 20 7645 0777.

Disciplinary rules: important notice

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

Examples of matters which may impact suitability to remain a member include (but are not limited to): whether in the course of work, a member has committed any act or default likely to bring discredit to them, the Institute, or the securities, investment, wealth and financial planning professions; if a member has performed their work incompetently; and, if a member has failed to satisfy a judgement debt, has made an assignment for the benefit of creditors, a bankruptcy or interim order has been made against them, or if the member has entered into a voluntary arrangement as defined in the Insolvency Act 1986.

More information at *cisi.org/mrules*.

WHY TALKING ABOUT THE MENOPAUSE IS A MUST – EVEN IF IT FEELS UNCOMFORTABLE

Clare Moffat, head of the Intermediary Development & Technical Team at Royal London, on the impact of menopause on pension savings

Women face several challenges which limit their ability to save for retirement, and ultimately contribute to the gender pension gap. These include an unequal distribution of caring responsibilities, the eligibility criteria for automatic enrolment, which disadvantages those (mainly women) in part-time work, and the menopause.

Despite this being a life event that almost all women will encounter, it is a factor vastly unregistered when discussing women's retirement savings.

Analysis by Royal London demonstrates the dramatic impact the menopause can have on women's pension savings. Our example was based on a pension fund of £100k at age 50, earning £40k with 2.5% wage growth until state pension age of 67, 5% investment growth (not including charges), monthly contributions of 10% and a 50% reduction in working hours/pay.

We found that a 50-year-old woman in full-time work until the state pension age of 67 could be better off by over £126k in pension savings, compared with a counterpart who stopped working at the same age.

Women reducing their working hours at age 50 could lose out on £63k in their pension pot. Being able to save during this stage of life is critical to achieve healthy retirement savings.

We need to help employers help employees so that they don't have to reduce their hours or stop work and can have open and honest conversations about how they feel. And we need to help female clients by asking the right questions and showing the difference it could have on their retirement. The menopause isn't going away – we just need to get better at talking about it.

CISI FINANCIAL PLANNING CORPORATE SUPPORTERS MAR 2023

Gold

Royal London
adviser.royallondon.com

Silver

Betafolio
www.betafolio.co.uk

TIME Investments
www.time-investments.com

Corporate

AIC
www.theaic.co.uk

Canada Life
www.canadalife.co.uk

Cascade
www.cascade.co.uk

Dimensional Fund Advisors
www.dfauk.com

Independent Health Care Solutions
www.ihcs.co.uk

Jupiter Asset Management
www.jupiteram.com

Just Adviser
www.justadviser.com

M&G Investments
www.mandg.co.uk

M&G Wealth
www.mandg.com/wealth

Octopus Investments
www.octopusinvestments.com

Prudential
www.pru.co.uk

Tenet
www.tenet.co.uk

Transact
www.transact-online.co.uk

Vanguard
www.vanguard.co.uk

Affiliate

HANetf
www.hanetf.com

RISK AND OPPORTUNITIES IN 2023

M&G Investments' chief investment officers (CIOs) consider the key issues that could shape financial markets in 2023

Fabiana Fedeli, CIO Equities, Multi Asset and Sustainability
With inflation, rising interest rates, and the threat of recession likely to be front of investors' minds, this is not a market for 'broad strokes' investing. There could be opportunities for active investors to harvest alpha but selectivity will be key. Longer term themes such as renewables and infrastructure remain appealing, irrespective of the near-term economic situation. I also believe sustainable investing will become mainstream in the coming years, as a key solution to the world's social and environmental challenges.

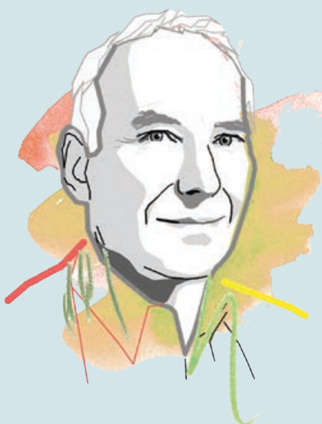
Jim Leaviss, CIO Public Fixed Income
After a tough year, I believe bond markets look interesting currently. Inflation is likely to ease in the coming months, and central banks may slow the pace of their interest rate hikes. In particular, I see value among corporate bonds, where the market is pricing in a high level of defaults, and emerging market debt, although it is important to be selective.

Will Nicoll, CIO Private and Alternative Assets
Private markets are a broad and versatile collection of asset classes, and some parts are well placed to weather any challenging conditions. There could be interesting value opportunities for selective investors, while supportive tailwinds such as increased interest in sustainable and impact investing could help the asset class continue to grow.

To read the full note and watch the video, visit bit.ly/2023investment

The value of the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise and you may get back less than you originally invested.

The views expressed here should not be taken as a recommendation, advice, or forecast.



FIRST PERSON

Beware of forecasters

Anthony Hilton
FCSI(Hon)

WORRIES ABOUT RECESSION MAY BE OVERDONE, ESPECIALLY IF DOUBLE-DIGIT INFLATION PROVES TO BE TRANSIENT

In 1966 the great economist Paul Samuelson famously quipped that the market has forecast nine of the past five recessions. Fifty years on, society remains fixated by forecasts.

Thus in 2022 most forecasters said much of the Western world was heading for inflation and recession – mainly due to the hangover from the Covid-19 shock on supply and demand, and the energy shock from the war in Ukraine. Politicians, central bankers, the markets all agreed.

So the US Federal Reserve (Fed) began to push interest rates up and was followed by several other countries.

According to economic theory, pushing up real interest rates dampens the economy partly because it lowers the level of investment by firms. It also hammers heavily indebted companies, who then struggle to pay the extra interest. And it hits consumers, partly through higher mortgage payments, and because they are less likely to spend on discretionary items, like going out. Hence pubs, restaurants, and travel companies also struggle.

The authorities think they need more unemployment so workers don't strike for more money – though they tend not to say this publicly. Most economists seem to agree – particularly those who work in the City and are tuned in to markets.

But there are dissenting voices. For example, Professor Louis Brennan of Trinity Business School in Dublin, in a letter published in the *Financial Times* (*FT*) (9 November 2022), says profit not wages is the inflation problem. The growth of mega-corporations means these big companies are oligopolies and can push up prices with no qualms, whereas small companies are constrained by their markets and competitive pressures.

Even more telling is Andrew Smithers, founder of an economics consultancy, who says in an opinion piece for the *FT* (30 March 2022) that conventional macroeconomics is simply wrong. Conventional macroeconomic theory works on untried assumptions, he says, whereas he has formed his own conclusions based on available data. He finds that in the real world, short-term interest rates (and share prices) have little long-term effect on the real cost of capital and investment. "We must stop using consensus theory both because it is wrong and because policies based on it regularly generate financial crises," he writes. "Many will wish to ignore this because it is incompatible with consensus theory. But it is vital for our future."

A book written 25 years ago, *The fortune sellers: The big business of buying and selling predictions*, by forecaster William Sherden, makes a different point. Economists, stock market analysts, scientists, trend spotters were all at it, writes Sherden, but "their forecasts are about as reliable as the fifty-fifty odds of flipping a coin … most consist of conjecture, unproved theory, or the extrapolation of past trends, which anyone could do."

A decade later, John Ioannidis, a Stanford, California professor, published a paper called 'Why most published research findings are false'. He said, in some ways echoing Smithers, this was largely because the assumptions which underpin a theory don't stand up in the real world.

So, putting up interest rates to curb inflation causes more problems than it solves. But some measures of inflation do seem to be mitigating. In August 2022 virtually everything was going up. But in November 2022, according to an opinion piece by *FT* columnist Ruchir Sharma, cargo shipping prices were plummeting, delays at ports were shortening, and supply chain shortages turned into gluts.

> **"Some measures of inflation do seem to be mitigating"**

The change in supply is nowhere more visible than in gas. It surged to over €300 per megawatt hour at its August 2022 peak. But in late autumn it was about 80% lower. Russia used to supply 30–40% of Europe's gas. Now it is barely a trickle. European demand has been cut by 10%, and supplies from the US, the Middle East, and Norway have made up the difference, though gas prices are still well above pre-pandemic levels.

Arguably, the real cause of worldwide inflation is the strength of the dollar, which surged in 2022. This adds to inflation in the developed economies, other than the US. It adds even more to inflation in the emerging economies, largely because they import a lot and their currencies are at the wrong end of the dollar surge. The Fed raising interest rates makes the dollar even stronger, and inflation even worse. As former US Treasury Secretary John Connally once observed to European finance ministers in 1971: "The dollar is our currency but it is your problem."

So, if the world wants lower inflation, it should in fact sell dollars and urge the US authorities to do the same – as happened at the Louvre Accord in 1987.

Or the Fed could reverse itself and lower interest rates. But, at the risk of making a forecast, neither is likely to happen soon. ●

ILLUSTRATION: PADDY MILLS/SYNERGY

PHOTOGRAPHY: CHARLIE SURBEY

global insights

pp.16–23
Special report: Demand for cheaper funds drives growth in share indices

pp.29–33
Corporate insolvency threat

pp.34–36
Weaknesses in global corporate reporting

pp.37–40
Pension freedoms risk and reward

pp.41–44
Being an expert witness

Demand for cheaper funds drives growth in share indices

MUCH OF THE AVALANCHE OF INVESTMENT INTO PASSIVE FUNDS IS GOING INTO PRODUCTS TRACKING NUANCED INDICES, AS WELL AS STALWARTS SUCH AS THE S&P 500. **BRADLEY GERRARD** REPORTS ON THE SIGNIFICANT IMPACT OF INDEX INVESTING

The proliferation and development of share indices, which chart the value of a group of stocks and act as a benchmark against which fund managers are measured, has been a major theme of the investing world in recent years.

Commentators continue to focus their attention on active investing when analysing how investors react to an event. They will look, for example, at how investors could or should reposition themselves by buying shares in energy companies if they think oil prices might rise in response to events such as the war in Ukraine.

For better or worse, investors who have bought passive products have no such worries. They, and the firms that supply the products, don't have to react to the latest twists and turns of the headlines. The rules governing what is included in such products are already decided.

Passive investors usually also enjoy the benefit of lower costs compared with their active counterparts. The demand for these cheaper products has been a major factor in driving the number of indices available.

The growth in indices, and investing based on them, has consequences. For instance, a greater focus on a specific theme, such as environmental, social, and governance (ESG), may bring more concentration risk. And the universal requirement for indices and the passive products following them to rebalance creates arbitrage opportunities for active managers.

With single indexing companies calculating hundreds of thousands of indices daily, the proliferation of indices has taken significant leaps and bounds since the humble beginnings of such a structure hundreds of years ago.

NOW AND THEN

London's first stock exchange was opened in 1570, eventually leading to Jonathan's Coffee House in 1698 publishing a list of currency, stock, and commodity prices. However, the oldest stock market index that most closely represents the one that many investment professionals use today is based in the US – the Dow Jones Industrial Average (DJIA), launched in 1896.

At launch it comprised 12 stocks of industrial companies, showing simple averages of the stock prices. The intention was (and still is) to provide investors and traders with an indication of how the aggregate value of the companies in the index change over time. The index now comprises 30 stocks, and it was only in 2018 when the last of the index's founding stocks, General Electric, was removed in favour of Walgreens Boots Alliance, after being in the DJIA continuously for more than 120 years.

IMAGE: ISTOCK

The change in composition of the DJIA more greatly reflects the development of the US economy rather than an alteration to how the index is constructed, with a notable change being Apple replacing AT&T in 2015, a sign that mobile telephony had become dominant over its fixed-line sibling.

But the number of indices has grown. Investors are now able to take far more granular stances rather than simply gaining exposure to a nation's economy, as expressed by an index such as Germany's DAX.

// DIFFERENT INDEX PROVIDERS USE DIFFERENT RULES TO CONSTRUCT THEIR INDICES //

The vast range of index products available facilitates a focus on, among other things, value or growth companies, lower-volatility stocks, or firms paying higher dividends. Other options include an equal-weighted index to avoid concentrating risk into a few large stocks.

INDEX CONSTRUCTION

Different index providers use different rules to construct their indices. Some indices, such as the FTSE 100, are weighted by market capitalisation. Others have equal weighting of the companies in their index. Others weight their indices by share price, such as the DJIA.

In an equal-weighted index, each constituent represents the same amount of the index, regardless of its size, while in the price-weighted approach, the share price dictates the weight of a company within an index, regardless of its size. This means a smaller company could command a bigger weighting in such an index based on its share price. However, price-weighted indices could be viewed

>>

as arbitrary when trying to determine the true value of a stock, given that one company could price its shares at US$1 and have one billion shares, while another could have shares priced at US$1,000 and have one million shares, giving them both a US$1bn market capitalisation.

Market capitalisation is now the predominant method for constructing indices. Size matters, and a 1% change in a big company's value is seen as more important in reflecting the overall direction of the market than a 1% change in the value of a small company. Indices can further refine the calculation by only including shares that are publicly traded. A company that is state-owned, for example, may part-privatise. If it sells 30% of the company on the stock market, many indices will only include 30% of the company's value in their weighting: the state's 70% will be excluded.

Some criticise cap-weighted indices for the distortions that can occur, though, such as the overweighting toward companies with the largest market capitalisation.

Before a stock can have an influence on a market, it needs to satisfy the selection criteria for inclusion in an index. With DJIA, the selection is made by Dow Jones Indices, meaning the companies included in the market are not always the largest. For the UK's FTSE 100, and almost all other major indices, criteria include minimum free float requirements and a liquidity test (see *cisi.org/indexchanges*).

BENCHMARKING, ACTIVE FUNDS, AND PASSIVE FUNDS

In a September 2020 CISI webinar on 'Selecting an appropriate investment benchmark', Daniel Broby, Chartered FCSI, chair of financial technology at Ulster University, explains that an index is "essentially an exercise in sampling, reducing an investment universe in a proportionate way, so you are getting a reflection of what you need".

This sampling allows active managers to benchmark their performance, usually against a broad market index, such as the MSCI World or S&P 500. But they can also use a narrower index, or even peer group performance. Steve Kowal, head of EMEA Wealth Management at MSCI, recommends that investors check that their active manager is using a benchmark representative of what they purport to deliver.

For example, "If you invest with an active fund manager that uses a value process, and they outperform the MSCI World (which they use as their benchmark) by 1 percentage point, that might look okay," he says, "but what if the active fund has only outperformed the MSCI World Value index by 20 basis points? If that's the case, then you haven't covered the costs of active management."

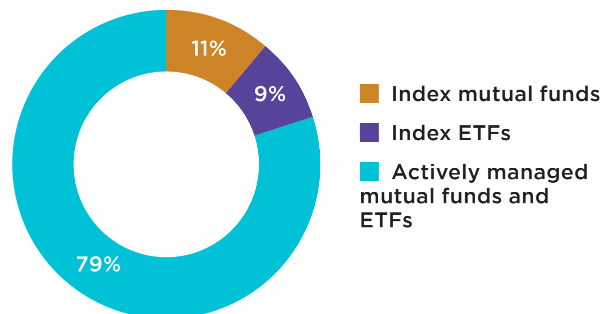
Essentially, if an active manager is claiming that they pursue a certain style, then they should benchmark their fund against the most appropriate index so that investors can view the strategy's performance against the most relevant comparator.

Passive funds, meanwhile, aim to mimic the performance of an underlying index. Indices form the basis of an index fund's or exchange-traded fund's (ETF's) investment framework. A passive fund tracking the FTSE 100, for instance, will rise and fall in value in tandem with any ups and downs in the underlying holdings,

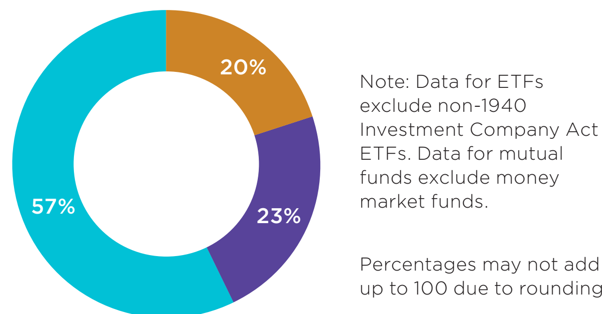
FIGURE 1: INDEX FUNDS HAVE GROWN AS A SHARE OF THE US FUND MARKET

Percentage of total net assets, year end

2011 TOTAL NET ASSETS: US$9.9 TRILLION



2021 TOTAL NET ASSETS: US$29.3 TRILLION



Note: Data for ETFs exclude non-1940 Investment Company Act ETFs. Data for mutual funds exclude money market funds.

Percentages may not add up to 100 due to rounding.

Source: 2022 Investment Company Institute fact book

meaning the ETF can be wholly passive between rebalancing, thus keeping transaction costs and turnover low.

Rebalancing – whereby index providers remove firms that no longer meet the index criteria and replace them with ones that do – only occurs at index calculation dates when the underlying index changes, such as the quarterly rebalancing of the FTSE 100.

Capitalisation weighted indices have low trading activity and low turnover because constituents are only moved in or out of the index at set intervals, usually quarterly.

For equal weighted or factor indices (the latter of which are designed to only include constituents that express a certain characteristic, like momentum, volatility or yield), the index can change substantially between calculation dates, bringing higher trading activity, higher turnover, and higher costs. With factor investing, a phenomenon called 'factor drift' occurs, whereby the difference between a value-orientated index fund and the underlying index it is tracking become more disparate. This means that when a rebalancing occurs, it is often greater – and therefore more costly – than a market-cap rebalance.

EXTERNAL FACTORS

A pronounced example of the effect of index inclusion on a specific share price relates to Moderna, the pharmaceuticals firm that shot to prominence during the Covid-19 pandemic.

The firm's inclusion in the S&P 500 was announced on 15 June 2021, prompting its shares to rise by 6% even before its actual entry onto the bourse on 21 July.

Researchers suggest that the 'S&P effect' – the upward trajectory in a firm's valuation after the announcement that it will be included in the index – adds between 3% and 6% to a company's valuation.

This was also visible with Tesla, the electric car maker, with its market capitalisation roughly doubling between the November 2020 announcement of its inclusion in the index and April 2021, according to an article published in *The Review* at the same time (*cisi.org/indices-powerful*). Of course, there are stock-specific reasons that could have helped this notable rise, such as the company's exciting growth prospects at the time.

But there are some large rebalances that take place that do not have a significant impact.

Indrani De, head of global investment research at FTSE Russell, says the rebalancing of a major index such as the Russell 3000 "doesn't lead to unusual [market] volatility, because it is rules based and the process is designed to give investors considerable lead time before the actual index reconstitution takes place".

// INDEX PROVIDERS ARE CONTINUING TO COME UP WITH MORE SPECIALIST OFFERINGS //

"Transparency is key to making sure the market is not surprised about which constituents are going in and which are going out," she says.

"This rebalance is one of the biggest trading events as we trade an entire index within a couple of seconds, but it causes minimal disruption and minimal volatility."

TRANSPARENCY AND LIQUIDITY

The seemingly unstoppable growth in passive funds is undeniably positive for index providers.

Mark Northway, investment director at Sparrows Capital, explains that the use of third-party indices requires passive funds to pay licence fees and asset-based fees (linked to the size of the fund) to the index provider, "but how much is very opaque", he says.

"The last time we looked at this issue, it was almost impossible to identify how much was being paid by individual ETFs, as the fund manager tends to report a single fee for the management of the ETF, which covers the various things it pays for."

He adds that the picture is further complicated by the fact this figure for management costs is often a net figure, which includes the income from stock lending. "In a world which has become transparent, with regulators disaggregating fees so that investors can see individual components, it is odd that in the ETF world you cannot get a picture of what is going on at a broken-down level, even in annual reports."

This lack of clarity may need to be rectified if more sophisticated versions of passive funds, with more complex strategies and therefore higher costs that need to be disaggregated, become available to consumers.

As it stands, index providers are continuing to come up with more specialist offerings. This includes a whole host of different indices to cover ESG

>>

>> themes, as well as products focused on specific sectors, such as finance.

But if the sub-set of stocks in a thematic index is narrow or fails to provide enough liquidity in comparison with the popularity of the strategy, this can cause problems.

In April 2021, two BlackRock ETFs were forced to sell billions of dollars worth of holdings as the S&P-run index they tracked became too popular.

Between them, the US-domiciled iShares Global Clean Energy ETF and the European-based UCITS (Undertakings for Collective Investment in Transferable Securities) equivalent had amassed nearly US$11bn between them, compared with just US$760m in January 2020, as investors increasingly sought investments they perceived to be climate-friendly.

But the S&P Global Clean Energy index that the pair of ETFs followed only consisted of 30 stocks, a decent proportion of which were small caps.

In a bid to take action, S&P expanded the index to a 'target constituent count of 100', but this incident led to some very large, forced sales and very large, forced buys being publicised before they took place. For example, New Zealand-based Meridian Energy previously made up 4.23% of the underlying index, but now only makes up 0.31%.

// INDEX CONSTRUCTION IS OFTEN OPAQUE //

It is highly likely that arbitragers took advantage of the gap between the announcement of a rebalancing in March 2021 and its execution on 19 April, according to Mark Northway. This means they could have sold their exposure to these stocks before the BlackRock ETFs did – meaning the ETFs are potentially selling them at a lower price – and then the arbitragers could have bought the relevant stocks before the rebalancing took effect – which potentially means the ETFs would be buying the stocks at a higher price.

TOO POWERFUL?

Index providers have the ultimate say on index rules, which essentially dictate which companies or countries feature in an index.

However, index providers should abide by full transparency in regard to their existing rules and any (proposed) rule changes, while also consulting broadly with internal and external advisers, as well as the wider financial community.

As Steve Kowal states, index providers want their products to be useful for clients. If clients can't use an index, they will turn to other major providers in a competitive market.

There are still differences of opinion, though, between index providers in regard to the inclusion of some securities.

South Korea presents a conundrum for index providers, many of whom list the economy in emerging market indices, despite it being listed as developed by the United Nations Conference on Trade and Development. A stumbling block to the country's inclusion in developed market indices, which is out of index providers' control, has been the absence of an offshore currency market for the South Korean won.

Daniel Broby suggests if every index provider simultaneously upgraded the Asian nation to developed market status, it would be the "biggest portfolio trade the world has ever seen".

This would be because every passive emerging market fund would need to relinquish exposure to South Korea, and every passive developed market fund would need to buy up exposure to the country.

The nation is lobbying the likes of MSCI to be included in its developed market index. In MSCI's June 2022 review, the country remains in the emerging market index, but it is included in some developed indices.

This means that if investors track emerging and developed market indices with different tracker funds or ETFs, they may want to check they are not doubly exposed to South Korea.

Another notable example of index providers having an element of control over when investors can access a market is the inclusion of China A shares in emerging market indices. In 2017 MSCI agreed an inclusion ratio of 5% of large-cap China A shares (since upgraded to 20% and including mid-cap shares), while FTSE Russell only completed its first phase of China A shares inclusion in mid-2020, weighting the exposure at 6%.

Although the Chinese authorities arguably had the most dominant role in how quickly A shares were internationally available via its methodical regulations, the index providers could have more quickly enabled access to some A shares in their broad market indices.

THE ESG RIDDLE

The clamour for fixed rules, definitions and processes within global financial services is arguably at odds with the rising prominence of ESG.

One might expect that certain characteristics make a company score high or low when establishing their ESG qualities.

But judging by the ESG indices of the largest providers, such as MSCI, S&P Global and Sustainalytics, subjectivity still plays a major role in defining ESG benchmarks.

Research by MIT in 2019 shows an average correlation among the six largest ESG rating agencies of 0.61 – well below the 0.99 correlation between the credit ratings of Moody's and Standard & Poor's.

The International Organization of Securities Commissions (IOSCO) has called for oversight of ESG ratings and data product providers. The International Financial Reporting Standards (IFRS) Foundation, which seeks to develop high-quality, understandable, enforceable, and globally accepted accounting and sustainability disclosure standards, has also weighed in. In 2021, it set up the International Sustainability Standards Board (ISSB) to meet investor demand on ESG.

Lee Clements, head of sustainable investment solutions at FTSE Russell, says there are now multiple regulations mandating enhanced disclosure of the ESG outcomes of indices, particularly those which claim to have sustainable characteristics.

"But if you look at the investment market, through to corporations and on to client solutions, there is a need for more disclosure," he says.

"Just 10% of companies in the Russell 2000 actually publish carbon emissions, so the inconsistency and lack of correlation in indices comes from the fact that the data is not disclosed at the starting point."

He added there was a drive to ensure transparency around how data is transferred into ESG scores that link to inclusion in an ESG index, as well as better disclosure of data around whether an ESG-skewed index performs better on a sustainable/responsible basis (such as lower carbon emissions) than the parent index it is derived from.

The enhanced EU's Sustainable Finance Disclosure Regulations, in effect since 1 January 2023, represent another hurdle that financial market participants, including index providers, will have to navigate.

But the focus on transparency and data seems preferable for many in the index world, as opposed to there being a rigid regulatory framework about what an ESG investment is.

Gareth Parker, chief indexing officer at Morningstar, says: "In principle, Morningstar feels that there are legitimate differences of opinion on ESG and legitimate differences about what ESG should be, and we feel as long as we create properly built, well-governed indexes then it's appropriate for there to be different indices for investors to choose."

Furthermore, while many index providers produce factsheets to denote what an index includes, Scott Klimo, chief investment officer at Saturna Capital, says in a CISI webinar, 'Active and index investing', that "index construction is often opaque".

He highlights how different seemingly similar indices can be, and that the choice of one over another could lead to unexpectedly high exposures to certain geographies, suggesting that active management could be advantageous for investors who wish to more closely manage their country weightings.

"In the MSCI All-Countries World index, the top five countries are the US, Japan, China, the UK and Canada, but the MSCI ACW Islamic index has the US, and then Switzerland in second place making up 10% of the index even though it isn't even in the top ten of the conventional index.

"So you might not necessarily have the type of country exposure that makes sense for you."

Countries have made significant efforts to gain inclusion in market indices.

Kuwait, for example, in 2017 began on the road towards upgrading from frontier to emerging market in the MSCI index. Its Market Development Project "brought numerous regulatory and operational enhancements to the Kuwaiti equity

>>

Active and index investing
Our webinar on CISI TV discusses an approach to active investing, and how to construct portfolios with a Shariah screening process.
cisi.org/active-index

>> market, which have significantly opened it to international institutional investors," MSCI said in a blog written at the time of its inclusion in December 2020.

// THERE HAS BEEN A PROLIFERATION OF SPECIALIST INDICES WHICH ARE EASIER TO BEAT //

"These include the removal of foreign-ownership restrictions on listed banks, simplification of requirements for investor registrations, improvement of the clearing and settlement mechanism to help prevent failed trades and an improved false-trade mechanism to limit brokers' access to investors' custody accounts."

REGULATORY RUMBLINGS

The US Securities and Exchange Commission (SEC) is assessing whether to tighten rules on index providers due to their growing influence on global asset management.

The regulator, chaired by Gary Gensler, is investigating whether companies such as MSCI, S&P Dow Jones Indices, and FTSE Russell should be reclassified from information providers to investment advisers, which could have profound implications for the way they are regulated.

Such a change would mean index providers could be treated the same way as fund managers under the Investment Advisers Act 1940.

In a June 2022 statement, SEC Commissioner Caroline A Crenshaw puts the question of reclassification to the public, speaking of the "prominent role" that index providers play in the asset management sector. Citing results from a global benchmark survey, she adds that in 2020 there were approximately three million indices, ranging in type from broad-based to narrow, customised, or bespoke for specific users.

She points to their function as a "measuring stick for fund or manager performance or compensation, or as guideposts in academic research", adding that index providers "appear to exercise significant discretion in the performance of their services", noting that they can determine which securities to include in the bucket of an index, "what weight each should be given, and how often those buckets should be reconstituted or rebalanced".

But Gareth Parker, chief indexing officer at Morningstar, says it is inappropriate to consider index providers as investment advisers because they don't make investment decisions; they provide benchmarks or tradeable products for issuers.

"There are EU benchmark rules that are extra-territorial, meaning they even impact US index providers, who have to be compliant with them. This means many index providers are already compliant with appropriate regulations that deal with issues such as data quality, conflicts of interest, competence of staff and other issues."

But some argue the relationship between index providers and fund managers is becoming more intertwined, via the likes of bespoke thematic indexes created for specific fund managers.

A NEW DAWN

Gone are the days when index providers mostly offered just broad-based indices for active managers to benchmark against and passive ones to track. Proponents of the explosion in the number of indices often cite the benefits to retail investors who, they state, can now access the types of strategies through passive funds and ETFs that would previously have only been accessible for wealthy individuals and institutions.

Academics such as Daniel Broby, however, argue that because the optimal index is hard to beat from an active management perspective, "there has been a proliferation of specialist indices which are easier to beat". He says that the popular reason given for the creation of these is a desire for "bespoke investment strategies" but "it means that the index has moved from being an impartial measurement benchmark to one which is selectively chosen by fund management companies".

Essentially, Broby argues that over-engineering of an index is being sold as positive for investors, because it offers them greater choice, but that these specialist indices are specifically created by fund management companies to make them easier to beat.

The distinction between active and passive is often blurred. "The likes of

fundamental indices are simply broad market indices with a tilt, and you could argue that they are really an active management product disguised as beta," says Daniel.

FURTHER EVOLUTION

Many ESG-related indices are being created – albeit establishing what is and is not a 'sustainable' or 'responsible' company remains extremely objective – as are other bespoke indices to match the growing number of bespoke ETFs.

Mark Northway, however, says that innovation should be around the investor experience, with the focus on removing inefficiencies that index users can suffer due to the way ETFs operate at present.

So far, changing client demand, new sources of risk and return, and changing markets have all contributed to the evolution of indices, with institutional clients increasingly seeking new thematic indices and retail investors increasingly engaging in direct indexing.

Direct indexing involves an investor buying each stock of an index – such as the FTSE 100 – within a taxable account rather than buying a fund that holds them. What this allows investors to do is to engage in tax-loss harvesting, which involves selling positions that are down, 'harvesting' or recognising those losses, and then using those to offset capital gains from other positions.

David Sol adds that regardless of the evolution within indices, all his company's more than one million indices are rule-based, providing a systematic way to construct a theoretical investment strategy that people can pursue.

// ABOVE ALL, TRANSPARENCY IS KEY //

"As an analogy, we are in the business of making recipes, as these tell you which ingredients to add, in which order, and how high to heat them," he said.

"Anyone following the recipe ends up with the same dish – they know the price of the constituents in the index, which companies are in the index, and their weight."

As the evolution of indices continues, though, there could be some challenges to overcome.

OPERATIONAL HURDLES

Gareth Parker believes index providers will need better technology to handle increased amounts of data as indices become more specialised and thematic. The ability to handle data from various sources will be key, he says.

Elsewhere, if direct indexing continues to rise in popularity, an operational imperative could arise whereby index providers deal more directly with platforms or custodians.

Mark Northway says he can envision ETF providers being removed from the equation if direct indexing becomes more popular, with platforms potentially able to offer direct indexing in some form of tax wrapper.

Steve Kowal adds that direct indexing in the US is becoming more popular because of 'tax-loss harvesting', which, as previously mentioned, is where investors offset tax gains from successful investments with tax losses from unsuccessful ones. One challenge is that direct indexing puts the onus on the adviser or wealth manager to monitor the selection of individual investments made by their clients.

"It is not a free lunch and comes at a cost," Steve said. "If you want the MSCI World Leaders, you can probably get that for 20 basis points, but if you want a personalised version, then you'll pay more, possibly more than double."

Direct indexing is also more popular in the US because of the number of self-investment platforms with commission-free trading, something that is less ubiquitous in Europe.

Regardless of how indices develop from here, one overarching factor will always be a vital consideration: regulation.

As the aforementioned consultation by the SEC suggests, regulators around the globe will be keen to ensure that consumers are fully aware of the risks associated with new types f indexing or emerging asset classes. With around 180 countries having some form of regulatory framework for their respective financial services industries, there is perhaps an argument for a greater level of global coordination.

Above all, transparency is key. Investors need to know exactly what they are putting their money into, so they can best assess the risks and weigh them up against the potential rewards. ●

CISI CHIEF EXECUTIVE OFFICER TRACY VEGRO OBE SPEAKS TO **LEN WILLIAMS** ABOUT HER CAREER TO DATE AND HER AMBITIONS FOR THE ORGANISATION

Are we ready to step up?

Tracy Vegro doesn't mince her words. Speaking about the challenges that the global economy and the financial services sector are facing, she lists some critical issues, including the climate crisis, the war in Ukraine, rising inflation, energy shortages, and floods. Tracy says that "it's going to be a very difficult ecosystem" for the sector to navigate. Nevertheless, she also spies an opportunity for the sector: "Good investment advice and boosting financial literacy are at an absolute premium now. So, are we ready to step up?"

From politics to regulation

Tracy has worked on the "same core issues, which are generally public policy programmes and legislation to stimulate economic growth", throughout her career. She grew up in the north of England in Yorkshire and after university joined the UK Civil Service as a graduate in the then Department for Trade and Industry (see CV boxout).

Her time in Whitehall saw her do a range of jobs, covering company law, financial services, regional policy, skills and enterprise, and after progressing to the Senior Civil Service in the Department for Business, included stints in the Government Equality Unit and later in the then Department of Energy and Climate Change. She was also seconded to spend time working at the Co-operative Bank, after headline-grabbing lapses heralded a recapitalisation programme and review of governance under the late Lord Myners, which exposed her to a commercial environment.

Tracy worked under numerous ministers and different complexions of government: including Conservative-led, Labour-led, and also the Conservative and Liberal Democrat coalition government of the early 2010s. "As a civil servant, you have to be neutral; you're not allowed to be in any way partisan," she says. The variety these roles offer "keeps you motivated and teaches you to focus on analysing data and making changes because you have to keep looking at issues afresh and from the perspective of value for money for the taxpayer. One day it is one minister in charge, then post an election, there may be another with completely different opinions coming in".

This experience also taught her the importance of basing decisions on evidence when devising and implementing government policy, and she has taken this approach with her everywhere she has worked. "Because if you're spending a huge amount of taxpayers' money, members' money, shareholders' money, potentially an investor's money, you have to know that you've analysed the pros and the cons of something."

In 2016, Tracy moved from the Civil Service to work at regulatory authorities. She spent four years at the Financial

>>

PHOTOGRAPHY: CHARLIE SURBEY

CV

Feb 2023–present Chair, Regulatory Response Unit, LawtechUK

Sep 2022–present Chief executive officer, CISI

Aug 2022–present Non-executive director, Salix Finance

Jan 2021 – Awarded an OBE for services to business and diversity

Mar 2020–Sep 2022 Executive director, strategy and innovation, Solicitors Regulation Authority

Mar 2016–Mar 2020 Executive director, strategy and resources, Financial Reporting Council

Oct 2013–Mar 2016 Director of policy, Co-operative Group (seconded from Whitehall)

Apr 2009–Mar 2016 Director, energy efficiency and consumers, Department of Energy and Climate Change

Apr 2007–Apr 2009 Director of enterprise strategy, Department of Business

// IT'S BETTER TO HAVE EVERYTHING ON THE TABLE //

>> Reporting Council (FRC), which oversees auditors, accountants, and actuaries, then in 2020 was appointed executive director for strategy and innovation at the Solicitors Regulation Authority. Both bodies are governed largely by public policy and legislation made in Whitehall, meaning that Tracy was on the receiving end of policy that, as a civil servant, she had helped design.

Connecting with members and wider society

Tracy's first task as CEO, she says, will be to listen to members and people in the organisation, represent their interests, ensuring that the Institute learns from the diversity of membership – 45,000 members in over 100 countries, "all of whom will be going through slightly different experiences".

Naturally enough, she also plans to "develop and grow" the CISI and is excited about some of the organisation's charitable initiatives, such as the Future Foundation (an independent grant-giving charity that the CISI has funded to improve people's financial literacy). That said, developing the CISI may involve doing things differently. "We can all predict the next ten years will be different. You have to make any organisation you lead fit for the future."

One area in which she sees real opportunities for the CISI is in expanding wider society's understanding of financial services and what they can do for people. This improved financial awareness might be provided through offering education about things like pensions, student loans, energy bills, or pro bono advice for people at different life stages (Tracy points to the CISI Financial Planning Week, held annually in October, during which financial planners offer free sessions to the public, as an example). She asks, "what do we, as financial services professionals, need to prepare people for?"

Under her leadership, the CISI will also seek to understand and offer informed comment and insights on various policies and legislation coming through, such as the UK's Financial Services and Markets Bill and Consumer Duty principles, as well as issues around international opportunities now that the country has left the EU. She notes that the CISI is already part of the Chartered Body Alliance (Chartered Banker Institute, Chartered Insurance Institute, CISI), and she'd like to expand the influence of this alliance "to become more than the sum of its parts" through greater collaboration, and using the alliance's combined influence.

Leadership style

"I'd want to say I'm visible and approachable and fair. I can make a tough decision, but I certainly want to hear different people's opinions," says Tracy. She strongly encourages everyone to speak up and make their voices heard, even if their view is discounted, because "it's better to have everything on the table, and then let's mutually decide what's right".

She believes that it's almost impossible to impose a culture on an organisation. However, it is vital that leaders "be seen to do what they say they'll do". Ultimately, this is about integrity and being authentic.

She also believes that in any job, "You've got to care. There's absolutely no point doing it if you don't care about the outcomes."

Being a good leader is also about expressing a genuine interest in people – a quality that Tracy, an only child, developed early in her life. "Sometimes people tell me I'm the classic only child because I notice loads of things about everybody." Tracy learned to make friends quickly or she would have been "stuck at home" alone. As if to illustrate this point, Tracy strikes up a conversation with a waiter – we're chatting in the lobby of a hotel in central London – who comes by to ask if we would like another coffee.

Diversity, equity, and inclusion

In 2021, Tracy was awarded an OBE (Order of the British Empire) for 'services to business and to diversity'.

In 2004, she was the senior civil servant appointed to a business-led review for the UK government, the Women and Work Commission, which looked at things like how "the choices girls made about their exams, whether they went into STEM [Science, Technology, Engineering and Mathematics] subjects, whether they studied finance, really then influenced where they got to" in their careers. The commission produced some 40 recommendations that could help contribute to overcoming the gender pay gap and other kinds of inequality.

She also continued this work during her time at the FRC, where she worked on boosting diversity and gender representation on boards. The work involved research and testing to find out what techniques might help encourage more equal gender representation in the higher echelons of business – to see whether things like quotas, mentoring, and similar initiatives would lead to more women progressing to senior roles.

As a mother of twin daughters, Tracy says it is important to set an example. "The more women that stay in the workplace and take advantage of different flexibilities, and indeed are vocal about demanding them, the more we will see change embedded in organisations."

She adds that diversity shouldn't just be something organisations do for the sake of it. "Just look at the classic thing that every management theory tells you – that you must avoid groupthink. Well, isn't diversity the answer to avoiding groupthink? So, I'm always a little bit surprised when people say to me, 'oh, it's very difficult,' or 'we'd like to do more, but it's hard,' because I think, 'what's stopping you?'"

She also volunteers time where she can and tries to support small charities, including The Listening Place, a charity where people can get face-to-face help and talk openly about their mental health, and Speakers for Schools, which sees professionals help bright kids who might not get parental assistance to do things like file university applications or seek out work experience. She chooses to support these charities because "they're issues that matter to me, the mental wellbeing of people, especially youngsters, giving everybody a stake and a chance is quite a big motivator".

That desire to give everyone a stake in society feeds into much of Tracy's work. Speaking again about the global economic, social, and environmental outlook, she knows full well how challenging the coming months and years will be. Nevertheless, she appears confident about the impact organisations like the CISI can have in challenging times, particularly by making financial services more accessible to wider society. "I think my motivation to make a difference might be quite well utilised." ●

// DIVERSITY IS THE ANSWER TO AVOIDING GROUPTHINK //

IMAGE: ISTOCK

Corporate insolvency threat

WITH A PERFECT STORM OF CREDITORS NO LONGER KEPT AT BAY, RISING COSTS, SUPPLY CHAIN HELL, AND A WAR IN EUROPE, **PETER TAYLOR-WHIFFEN** ASKS WHETHER WE WILL SEE A GLOBAL SURGE IN INSOLVENCIES

Corporate insolvencies are likely to soar as government Covid-19 support schemes wind down around the world. A return to business as usual will expose a raft of vulnerable firms no longer able to rely on state loans and handouts to prop up their business models.

But the picture varies in different parts of the world, thanks to a disparity in lockdown measures, a wide spectrum of state support levels, and the contrasting rates of economic recovery across the globe – and that's before factoring in the impact of the war in Ukraine. So, is a global insolvency crisis coming, and if it is, what does this mean for investors trying to identify a sustainable business?

The number of global insolvencies, which dropped by 12% in 2020 and 2021, are likely to rise by 14% in 2023, according to a *Global insolvency report* published in May 2022 by credit insurance company Allianz Trade (formerly Euler Hermes), which expects half of all countries to return to their pre-pandemic levels of insolvencies by 2023 (see chart, p.30).

In England and Wales, the second quarter of 2022 saw the highest number of insolvencies for nearly 13 years, reports the Office for National Statistics, and more than one in ten UK businesses have reported a moderate to severe risk of insolvency.

A global outlook

Other countries are also seeing spikes. According to the Allianz Trade report, Austria is forecast to have the largest growth in insolvencies (up 63%) followed by India (49%), Ireland (40%), Belgium (39%), and the UK (37%), with many other significant increases also in Europe – the Netherlands, Switzerland, Greece, Hungary, Lithuania, and Latvia forecast to see an increase over 20%.

// A RETURN TO BUSINESS AS USUAL WILL EXPOSE A RAFT OF VULNERABLE FIRMS //

>>

INSOLVENCIES BY COUNTRY

	% of World GDP **	% of Global Index	Business insolvencies level					Business insolvencies growth					Comparison with 2019 level		
			2019	2020	2021	2022f	2023f	2019	2020	2021	2022f	2023f	2021	2022	2023
GLOBAL INDEX *	**86.6**	**100**	**122**	**108**	**95**	**105**	**120**	**8%**	**-12%**	**-12%**	**10%**	**14%**	**-22%**	**-14%**	**-2%**
North America Index *	26.7	30.8	62	58	39	42	52	3%	-5%	-33%	9%	23%	-37%	-31%	-16%
U.S.	24.3	28.0	22 720	21 591	14 290	15 503	19 126	3%	-5%	-34%	8%	23%	-37%	-32%	-16%
Canada	2.1	2.5	2 746	2 108	1 942	2 292	2 635	3%	-23%	-8%	18%	15%	-29%	-17%	-4%
Latin America Index *	2.3	2.7	212	236	217	227	238	12%	11%	-8%	5%	5%	2%	7%	12%
Brazil	1.7	2.0	2 887	2 078	1 962	2 260	2 600	5%	-28%	-6%	15%	15%	-32%	-22%	-10%
Colombia	0.3	0.4	1 272	1 292	1 300	1 350	1 400	2%	2%	1%	4%	4%	2%	6%	10%
Chile	0.4	0.4	1 701	1 885	1 506	1 550	1 600	23%	11%	-20%	3%	3%	-11%	-9%	-6%
Europe Index *	25.0	28.9	155	135	143	162	178	1%	-13%	6%	13%	10%	-7%	5%	15%
EU27+UK+Norway Index *	22.4	25.9	138	113	120	137	155	2%	-18%	6%	14%	13%	-13%	-1%	12%
EU27 Index *	18.8	21.7	148	123	131	147	168	2%	-17%	7%	12%	14%	-11%	-1%	14%
Euro zone Index *	15.2	17.5	147	119	128	143	165	1%	-19%	7%	12%	16%	-13%	-3%	13%
Western Europe Index *	20.6	23.8	135	109	115	131	149	1%	-19%	6%	14%	14%	-15%	-3%	11%
Germany	4.5	5.2	18 749	15 840	13 993	14 600	16 130	-3%	-16%	-12%	4%	10%	-25%	-22%	-14%
France	3.1	3.6	51 434	31 992	28 184	32 510	43 300	-5%	-38%	-12%	15%	33%	-45%	-37%	-16%
United Kingdom	3.3	3.8	22 083	15 658	16 310	22 305	23 100	4%	-29%	4%	37%	4%	-26%	1%	5%
Italy	2.2	2.6	10 542	7 160	8 498	8 990	10 850	0%	-32%	19%	6%	21%	-19%	-15%	3%
Spain	1.5	1.8	4 162	3 945	5 125	5 550	6 250	6%	-5%	30%	8%	13%	23%	33%	50%
The Netherlands	1.1	1.2	3 792	3 177	1 818	2 250	3 130	4%	-16%	-43%	24%	39%	-52%	-41%	-17%
Switzerland	0.9	1.0	6 004	4 888	5 124	6 170	6 450	-4%	-19%	5%	20%	5%	-15%	3%	7%
Sweden	0.7	0.8	7 358	7 296	6 463	6 850	7 350	2%	-1%	-11%	6%	7%	-12%	-7%	0%
Norway	0.5	0.5	5 013	4 101	3 325	3 740	4 280	0%	-18%	-19%	12%	14%	-34%	-25%	-15%
Belgium	0.6	0.7	10 598	7 203	6 533	9 100	10 000	7%	-32%	-9%	39%	10%	-38%	-14%	-6%
Austria	0.5	0.6	5 018	3 034	3 034	4 950	5 500	1%	-40%	0%	63%	11%	-40%	-1%	10%
Denmark	0.4	0.5	2 590	2 221	2 175	2 530	2 700	6%	-14%	-2%	16%	7%	-16%	-2%	4%
Finland	0.3	0.4	2 989	2 471	2 804	3 100	3 250	1%	-17%	13%	11%	5%	-6%	4%	9%
Greece	0.2	0.3	63	57	57	70	85	-23%	-10%	0%	23%	21%	-10%	11%	35%
Portugal	0.3	0.3	2 560	2 464	2 195	2 230	2 580	-5%	-4%	-11%	2%	16%	-14%	-13%	1%
Ireland	0.5	0.6	568	575	401	560	650	-26%	1%	-30%	40%	16%	-29%	-1%	14%
Luxembourg	0.1	0.1	1 236	1 179	1 181	1 300	1 375	7%	-5%	0%	10%	6%	-4%	5%	11%
Central & Eastern Europe Index *	4.4	5.1	245	254	274	306	317	1%	4%	8%	12%	4%	12%	25%	29%
Russia	1.7	2.0	12 401	9 930	10 319	10 938	14 220	-5%	-20%	4%	6%	30%	-17%	-12%	15%
Turkey	0.8	1.0	14 050	15 946	17 184	19 200	18 500	3%	13%	8%	12%	-4%	22%	37%	32%
Poland	0.7	0.8	977	1 293	2 187	2 450	2 650	-1%	32%	69%	12%	8%	124%	151%	171%
Czech Republic	0.3	0.3	8 521	7 918	7 028	7 650	8 200	41%	-7%	-11%	9%	7%	-18%	-10%	-4%
Romania	0.3	0.4	6 524	5 694	6 144	7 150	7 900	-21%	-13%	8%	16%	10%	-6%	10%	21%
Hungary	0.2	0.2	5 176	4 293	5 005	6 300	6 800	-9%	-17%	17%	26%	8%	-3%	22%	31%
Slovakia	0.1	0.1	2 447	1 889	1 692	1 877	1 995	25%	-23%	-10%	11%	6%	-31%	-23%	-18%
Bulgaria	0.1	0.1	506	524	527	610	650	6%	4%	1%	16%	7%	4%	21%	28%
Lithuania	0.1	0.1	1 609	789	795	1 000	1 350	-23%	-51%	1%	26%	35%	-51%	-38%	-16%
Latvia	0.0	0.0	557	374	241	320	410	-6%	-33%	-36%	33%	28%	-57%	-43%	-26%
Estonia	0.0	0.0	271	341	308	360	380	-1%	26%	-10%	17%	6%	14%	33%	40%
Africa Index *	0.5	0.6	157	137	181	199	194	31%	-12%	32%	10%	-2%	15%	27%	24%
South Africa	0.4	0.5	2 042	2 035	1 932	2 000	2 100	11%	0%	-5%	4%	5%	-5%	-2%	3%
Morocco	0.1	0.2	8 477	6 620	10 550	11 800	11 300	35%	-22%	59%	12%	-4%	24%	39%	33%
Asia-Pacific Index *	32.1	37.1	139	119	94	102	119	19%	-14%	-21%	9%	17%	-33%	-27%	-14%
China	17.8	20.6	11 826	11 999	8 691	8 750	9 700	12%	1%	-28%	1%	11%	-27%	-26%	-18%
Japan	5.4	6.2	8 385	7 773	6 030	6 500	7 830	2%	-7%	-22%	8%	20%	-28%	-22%	-7%
India	3.1	3.6	1 924	736	770	1 150	1 600		-62%	5%	49%	39%	-60%	-40%	-17%
Australia	1.7	2.0	6 405	3 582	3 408	4 400	5 900	1%	-44%	-5%	29%	34%	-47%	-31%	-8%
South Korea	1.9	2.2	414	292	183	230	280	-12%	-29%	-37%	26%	22%	-56%	-44%	-32%
Taiwan	0.8	1.0	205	200	204	220	230	-6%	-2%	2%	8%	5%	0%	7%	12%
Singapore	0.4	0.5	287	200	191	240	250	39%	-30%	-5%	26%	4%	-33%	-16%	-13%
Hong Kong	0.4	0.5	244	234	299	299	330	-4%	-4%	28%	0%	10%	23%	23%	35%
New Zealand	0.3	0.3	1 907	1 619	1 500	1 600	1 700	-11%	-15%	-7%	7%	6%	-21%	-16%	-11%
Global with absolute number of insolvencies	86.6	100	106	85	80	92	105	1%	-19%	-6%	15%	14%	-24%	-13%	-1%
Global with relative number of firms **	86.6	100	179	163	169	188	204	8%	-9%	3%	11%	8%	-6%	5%	14%

(*) Global (or regional) insolvency index is the weighted sum of national indices, each country being weighted by the share of its GDP within the countries used in the sample (44 countries representing 87% of global GDP in 2021). National indices are based upon national sources or Allianz Trade internal data on insolvencies, using a base of 100 in year 2000. Forecasts are reviewed each quarter.
(**) GDP 2021 weighting at current exchange rates
Sources: national sources, OECD, Eurostat, Allianz Research (f:forecasts)
Data are available on the webapp MindYourReceivables

Source: Allianz Trade Global insolvency report

>> Allianz also expects insolvencies to soar in Australia (29%), South Korea (26%), and Singapore (26%), but it's a different story elsewhere in the Far East, with negligible or no change in China (1%) and Hong Kong (0%).

In countries where businesses did not enjoy a significant level of pandemic government support, insolvency rates are not tending to surge. This is true in much of Africa, says Amaechi Nsofor, head of Africa, insolvency and asset recovery at Grant Thornton.

"Support did not exist in the first place so it hasn't created a huge artificial comfort blanket that needs replacing," he says. "There's always been an insolvency crisis in Africa and non-performing loans have always been very high. Being 10–15% higher now doesn't really make that much difference."

But governments in Africa have, as a result of the pandemic, run down their foreign reserves on palliatives such as food, says Amaechi. They don't have enough left to "go into the market to buy up and defend their own local currencies", putting inflation out of control, he says.

A more significant trend stabilising insolvency numbers across Africa is a pan-continental shift away from liquidation to restructure and rescue businesses. "Previously the approach in places like Nigeria and South Africa was to focus on the local domestic recovery options," says Amaechi, "but those countries and banks have now fully exhausted low-hanging fruit in terms of going after local debtors, so I'd expect a shift to cross-border/international efforts."

A likely result of this is a swoop by vulture funds – such economies need outside interest to give them the infrastructure they need but without that infrastructure they can't attract the interest. But outside influence or support costs – bringing opportunity to buy distressed businesses to turn around. "Pan-African banks and development financial institutions are crying out for funds to buy up their non-performing loans," says Amaechi. "Distressed debt investors stand to make a quick buck in Africa."

Despite the Allianz forecast of 8% insolvency growth in the US in 2022, the business bankruptcy rate has, according to a report by the Administrative Office of the U.S. Courts, fallen 18.7% in the past year. The report shows the number of insolvencies declined from 16,140 to 13,125 in the 12 months to September 2022 – thanks largely to a combination of the Paycheck Protection Program (a US$953bn federal package which, although ended a year ago, still entitles many borrowers to 'loan forgiveness') and America's initially spectacular fiscal bounce back – its 5.7% economic growth in 2021 was the fastest since 1984.

IMAGE: ISTOCK

At the height of the pandemic, most national governments were propping up small businesses. An OECD survey of 55 states, published in May 2021, shows 91% deferred corporate tax, 87% offered loans, and around two-thirds offered support with energy costs and debt moratoria.

// LIQUIDITY HAS NEVER BEEN AS CRITICAL //

The removal of such support has been compounded across the world by continuing supply chain disruptions, transportation delays, goods shortages, high energy costs, and a global surge in inflation. Yet there are reasons a flood of insolvencies may not happen – at least, not yet. The Allianz report points to the global total cash holdings of listed firms being 30% higher at the start of 2022 than in 2019, and deposits of non-financial corporates being 29% higher in the eurozone and 57% higher in the US. The report also suggests the number of 'fragile firms' (firms at risk of insolvency in the next four years) has decreased across Europe – most >>

>> significantly in Italy (from 11% to 7%) and France (15% to 12%), but also in Germany (7% to 6%) and even in the UK (18% to 17%).

A closer look

These varying rates of recovery inevitably make it harder for investors to differentiate between strong companies and those that have been artificially propped up. "Liquidity has never been as critical," says Simon Longfield, restructuring advisory partner at UK-based business advisory firm FRP. "And I believe we will see a recalibration of deal metrics to factor in the challenges that businesses are now facing. Lower leverages will be the order of the day."

The removal of federal Covid 19 support is inevitably exposing vulnerable firms. Many of those that survive will have to restructure to do so, meaning, says Simon, "The fund management sector's attention will switch from M&A activity to discounted stressed and distressed assets."

// INTEREST RATES WILL LIKELY SOUND THE DEATH KNELL FOR MANY UNSUSTAINABLE COMPANIES //

Individual insolvencies may yet be kept at bay if the banks, which are arguably in a stronger position than they were in 2008, demonstrate more debt forgiveness. Chris Kennedy ACSI, managing director at US-based global turnaround specialists Alvarez & Marsal, says: "The purchase of asset-backed securities and the sale of billions of dollars of these products every month to the Fed has given the banks a massive amount of liquidity. This has come to a halt, and they no longer have that flow of sales or income, and quantitative tightening will impact them. But they are much better capitalised than last time round."

Tax regimes have also shown patience (at the end of 2021, the UK's HMRC was owed a record £65bn) and legislation is also encouraging forbearance. In the UK, the Corporate Insolvency and Governance Act 2020 (CIGA 2020), introduced to enable companies to restructure their balance sheets, will gradually have more impact as support measures disappear. The 20-day initial moratorium could, for example, be used more frequently when there's viable opportunity for a business to be rescued as a going concern. But does this simply prolong the artifice in weaker companies, protecting business owners while putting their investors at risk?

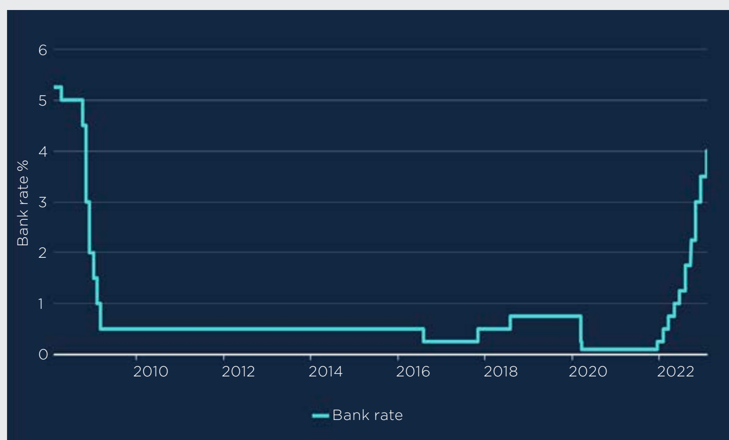
"Insolvency rates may be affected by business owners' expectations regarding the future," says Jean-Daniel Breton, chair of the Canadian Association of Insolvency and Restructuring Professionals (CAIRP). "If business owners believe the economy will deteriorate, they may decide to stop operations and liquidate, while if they believe the economy will generally get better, they may invest more, undertake restructuring measures, or show more resilience."

Welcoming change

So, would a proliferation of vulture funds swooping on vulnerable companies necessarily be a negative outcome – or is it an inevitable byproduct of capitalism that helps make the world go round? The latter, suggests Jean-Daniel: "We should not be looking at insolvency rates as necessarily being a 'bad thing'. Insolvency is a normal process that denotes a healthy economy. While we strive to avoid insolvencies and keep insolvency rates low, a total absence of insolvency in an economy would be indicative of a serious problem, namely either that the statutory framework does not allow the possibility of relief if one is in financial difficulty, or if the insolvency laws exist and are fair, an absence of insolvency cases would mean that business owners are not taking risks and entrepreneurship is being stymied."

There is an argument that reducing insolvencies and allowing

UK BANK RATE



Source: Bank of England

HERE ARE SOME CISI LEARNING RESOURCES YOU MAY FIND USEFUL

Insolvency and bankruptcy
cisi.org/insolvency

Managing operational risk
cisi.org/mor

Trading debt securities in an inflationary environment
cisi.org/debtsecurities

Business protection
cisi.org/businessprotection

Let's get down to business protection
cisi.org/businessprotection2

Corporate insolvency: the Covid-19 context
cisi.org/insolvency-covid

fundamentally weaker firms to limp along restricts opportunity and markets, exposing better managed companies to greater risk and competition that would otherwise not be there. This is arguably exacerbated by legislation that has provided heightened protection for business owners, for example, the UK's CIGA and the Coronavirus Act 2020, which suspended liability for wrongful trading, making it more difficult for insolvency practitioners to challenge directors over their conduct. The suspension ended in June 2021.

Interest rate rises will likely sound the death knell for many unsustainable companies whose future has already been made parlous by inflation. A rapid series of hikes has left the main US Fed funds rate at 4.5-4.75%, its highest in nearly 15 years as the US looks to combat double-digit inflation. This follows increases in Brazil, Canada, Australia, and Europe. Similarly, the Bank of England raising its key rate to 4% in February 2023 – it was 0.1% as recently as December 2021 – seems certain to further accelerate the UK's insolvency surge.

Rising interest rates

"Inflation is hard to tackle without driving up interest rates and making liquidity less available, which inevitably will be a driving force in many insolvencies," says Chris Kennedy. "Is that a flaw of capitalism? Probably. But what's the alternative?"

Capitalism is flawed but inflation is not being tamed by what's been done so far, he says, adding that interest rate rises and an increase in insolvencies are inevitable.

When the flaws manifest themselves in events such as the collapse of cryptocurrency firm FTX in 2022, (see 'The coming crypto crunch?' on CISI TV) and the collapse of Silicon Valley Bank in March 2023, they hit the headlines. Such is the turbulence that periodically affects most of the business world. The heavy fall of the S&P 500 in 2022 still left the index some 170% higher than it was ten years earlier. Like the bigger companies, the sort of firms that become insolvent are part of the same cycles. Most forecasters expect the S&P to resume its upward trajectory, even if it takes a while. Similarly, insolvencies may grow in 2023 but are likely to recede again as part of the cycle. ●

Weaknesses in global corporate reporting

THE SCALE OF INTERNATIONAL FINANCIAL CRIME REQUIRES REGULATORS TO BOOST COMPANY DISCLOSURE STANDARDS, REPORTS **BRADLEY GERRARD**

Knowing who owns what is a vital component of international financial security. But exposés such as 2016's Panama Papers and 2021's Pandora Papers show that significant progress is still needed. The former unveiled a trove of legal records pointing to a secretive offshore web of companies that hid crime, corruption, and wrongdoing. The latter exposed a shadow financial system that benefits the rich and famous.

Countries such as the UK are often seen as legislative bastions, but questions remain about what exactly Companies House, the government body that companies must register with, can and should do.

In February 2022, UK media widely reported that 761 companies had been registered to a flat above a takeaway shop, with estimates that roughly 11,000 bogus companies were registered in the UK in the year to February by Chinese fraudsters alone.

// 761 COMPANIES HAD BEEN REGISTERED TO A FLAT ABOVE A TAKEAWAY SHOP //

Fraud can even be in multicoloured, plain sight, with Westminster Council recently dealing with a spate of US-themed sweet shops, whose owners have allegedly been avoiding tax and selling counterfeit items. These shops often close down before authorities can track the owners, followed by another opening nearby.

It's the same story in many other jurisdictions worldwide. Authorities need to act to combat economic crime.

Differing standards

The UK's recent efforts to prevent registration of fraudulent companies include 2020 legislation requiring registered firms to notify Companies House of any discrepancies between the information that the firms hold about their 'beneficial owners' and information on the Companies House register of people with significant control.

A 'person with significant control' (PSC) is an individual who either owns or controls a company, also referred to as a beneficial owner.

Ensuring this information is correct and up to date helps improve the quality of public information on companies and speeds up anti-money laundering checks that must be made by banks and other financial institutions.

The UK government confirmed in November 2022 that it was, through the Economic Crime and Corporate Transparency Bill, seeking to expand the fee-raising powers of Companies House to enable the cost of investigative and enforcement activities that promote the integrity of the register, maintain a healthy business environment, and combat economic crime. The move is part of broader efforts by the government to tackle

fraud and address tax compliance risks among wealthy taxpayers, with Chancellor Jeremy Hunt confirming in the Autumn Statement 2022 that £79m would be invested in HMRC to allocate additional staff to the task.

Efforts to strengthen the system are laudable, but Max Heywood, head of public policy at financial crime risk management platform Elucidate, based in Germany, believes that simply having a robust register is insufficient. A 'multi-pronged approach' that includes financial intelligence units and crime-fighting bodies is also needed, he says, because "if one part of the system isn't coordinated – it could be banks or lawyers even – then there's a gap that criminals can get through".

Max points out that going back through all the existing data on Companies House and ascertaining its veracity is a huge task requiring significant resources. This is a major challenge for long-established legacy systems, and why countries with newly established frameworks often have more robust company registration systems.

Ukraine is a global leader in this area, says Max, largely down to having built its register from scratch within the past decade, meaning it was entirely digital from the beginning.

In 2015, Ukraine was the first country in the world to launch a public register of the beneficial owners of its registered corporate entities. In 2017 it became the first nation to integrate its national central register of beneficial ownership with the advocacy group Open Ownership, which is funded by governments, institutions, foundations, and the private sector.

Conversely, countries like Germany have an arguably complex system, with corporate registers managed at the federal state level, but with the *Handelsregister* (commercial register) acting as a single portal for access to sub-national registers.

The *Transparenzregister* is a register of beneficial ownership. However, it is unclear what impact the Court of Justice of the European Union's (CJEU) ruling on beneficial ownership will have for public access to this data. The CJEU has angered transparency campaigners by invalidating a provision of the fifth EU anti-money laundering (AML) directive that "guaranteed public access to information on companies' real owners", according to an article by anti-corruption organisation Transparency International.

IMAGE: ISTOCK

Obvious flaws

Company registration systems where there are few checks, or even none, provide an unobstructed platform from which money laundering can flourish.

The UK, for example, has been given short shrift by Transparency International, which, in its 2017 *Hiding in plain sight* report, identifies 766 UK companies that were used in 52 global corruption and money laundering cases.

Graham Barrow, a banking compliance expert and now director at The Dark Money Files – an educational project that includes a blog, podcasts, and events – writes extensively on money laundering and the scale to which it appears visible on Companies House.

In research conducted by Barrow, he generated a sample of limited liability partnerships (LLPs) and limited partnerships (LPs) by searching

// A MULTI-PRONGED APPROACH IS NEEDED //

>>

>>

Companies House for all listed entities with the word 'Impex' in their title, a phrase he'd noticed fairly regularly and understood to be a portmanteau of 'import/export'.

This search on Companies House generated a list of 403 active Scottish LPs and 69 active LLPs. Out of the 69 LLPs, just two had designated members with addresses in the UK, one had an address in France, and the remaining 66 had addresses in offshore locations.

But the "most shocking figure of all" in relation to these 69 companies, according to Graham, is that 44 of the 69 companies had annual accounts signed off by just two people: 28 of them were signed off by one man, and a further 16 were signed off by one woman.

"Anyone who looks at that list and is not shocked to the core is missing the point of this entire investigation," he says. "There is no way that a randomly selected group of entities should exhibit such a strong correlation. And this is just the tip of the iceberg of the signed-off accounts."

To further highlight the issue that the UK's company registration system faces, and one which is no doubt prevalent in other countries, Graham found 13 different nationalities of PSCs across 40 of his Impex sample. If a PSC is based overseas, it can make it difficult to track these people if regulatory or law enforcement agencies wish to do so.

But enforcement isn't that strong in the UK for British nationals either. According to a report by the International Consortium of Investigative Journalists (ICIJ), it wasn't until 2018 that the first person was successfully prosecuted for supplying false information to Companies House after setting up a company in the name of former Business Secretary Vince Cable MP and appointing him director without his knowledge.

Kevin Brewer pled guilty to the charges and was ordered to pay £12,000 in fines and costs. From then until February 2021, when the ICIJ published the story, there were just five prosecutions for supplying false information, despite what the ICIJ calls "overwhelming evidence that Companies House is littered with fictitious filings".

// STILL TOO MANY WEAK LINKS IN THE INTERNATIONAL CHAIN //

Global standards

The issue is a global one that has been high on the agenda of the intergovernmental Financial Action Task Force (FATF).

According to the 'outcomes' of an FATF plenary session held in Paris in October 2022, delegates discussed how to help countries and the private sector implement FATF's strengthened requirements on beneficial ownership to "prevent criminals from hiding illicit activity behind opaque corporate structures".

It was also announced at the meeting that guidance on beneficial ownership would be finalised in February 2023 after input from FATF stakeholders. Furthermore, the FATF said it would propose modifications to its standard on beneficial ownership of legal arrangements to ensure that information about the likes of trusts and other legal arrangements that commonly hide identities was more transparent.

Despite these developments, OECD countries and their dependencies account for 68% of the world's corporate tax abuse risks, according to the Tax Justice Network's Corporate Tax Haven Index for 2021. This has prompted calls from campaigners for OECD tax rules "to be superseded by a more robust and globally inclusive process at the United Nations, beginning with a UN tax convention", the body said.

No confirmation of validity or trustworthiness

While there are collaborative and proactive steps being taken by individual authorities, or groups of countries via the likes of FATF, there remains a significant way to go before globally common standards are prevalent.

There are still too many weak links in the international chain, as well as within individual nations.

Business leaders and owners might view such risks as removed from their everyday lives, but a failure to analyse third-party risk arguably exposes any firm.

The government's Check, Act and Review guidance on due diligence that firms should carry out on every third party they interact with highlights the importance of knowing who your firm is doing business with, no matter how small the contract or transaction.

Being registered on Companies House, or the vast majority of international registers, is no confirmation of validity or trustworthiness. Firms should undertake their own robust due diligence before accepting such companies as a customer. ●

IMAGE: EVA BEE/IKON IMAGES

Pension freedoms risk and reward

WITH REGULATORY CHANGE IMMINENT, **PETER TAYLOR-WHIFFEN** ASKS IF UK DC PENSION FUNDS ARE READY OR EVEN WILLING TO RISK MEMBER CONTRIBUTIONS FOR GREATER REWARD

The post-Brexit UK landscape offers significant opportunity to free DC pension funds but, to date, regulatory divergence has been minimal.

This includes the FCA's final rules, published in October 2021, for a new category of open-ended authorised funds, the long-term asset fund (LTAF), aimed at encouraging investment in long-term illiquid assets.

The goal is to broaden the horizons for investors who, according to the FCA, are "unable or unwilling" to invest in long-term assets. Previously, investment in these assets was usually via closed-ended structures such as limited partnerships, venture capital trusts, and investment trusts into FCA-authorised schemes.

Another change could stem from an ongoing review of the 0.75% charge cap on default funds in a DC scheme. In July

Defined benefit (DB) pension funds guarantee a specific level of payout based on employee salary and length of service. They have few restrictions on the asset classes in which they can invest.

Defined contribution (DC) schemes have heavily restricted investment opportunities. Their payouts are not guaranteed but depend instead on how much the employee has paid in, and how well the investments have done.

>>

>> 2022, the UK government updated its consultation document about 'Facilitating investment in illiquid assets', saying that excluding performance fees from the cap on charges in default arrangements could help trustees "get the best overall deal for members when investing in private equity and venture capital".

Positive member outcomes should be the primary focus, says Mark Searle, head of DC Investment at XPS Pensions Group. "Investing in less liquid assets is incredibly appealing for reasons covering potentially higher returns, diversification, and environmental, social, and governance (ESG) benefits. However, the risk of investing in less liquid assets is owned by the membership and any investment strategy should be mindful of their risk tolerance. This puts a different lens on the decision-making when considering illiquid assets, particularly if the default arrangement is already deemed adequate."

// THE RISK OF INVESTING IN LESS LIQUID ASSETS IS OWNED BY THE MEMBERSHIP //

The UK's relatively young DC pensions market – DC was common in the US in the mid-1970s, 20 years before it began gaining traction in Britain – currently enjoys far less freedom than those of other countries, yet by 2025, DC pension schemes will have become one of Britain's largest reserves. According to a 2021 report by the Bank of England, assets are expected to double from £500bn today to around £1tn in 2030, a sum which, if invested in illiquids, could seismically transform UK enterprise while giving savers a stake in the real economy.

Weighing up risk

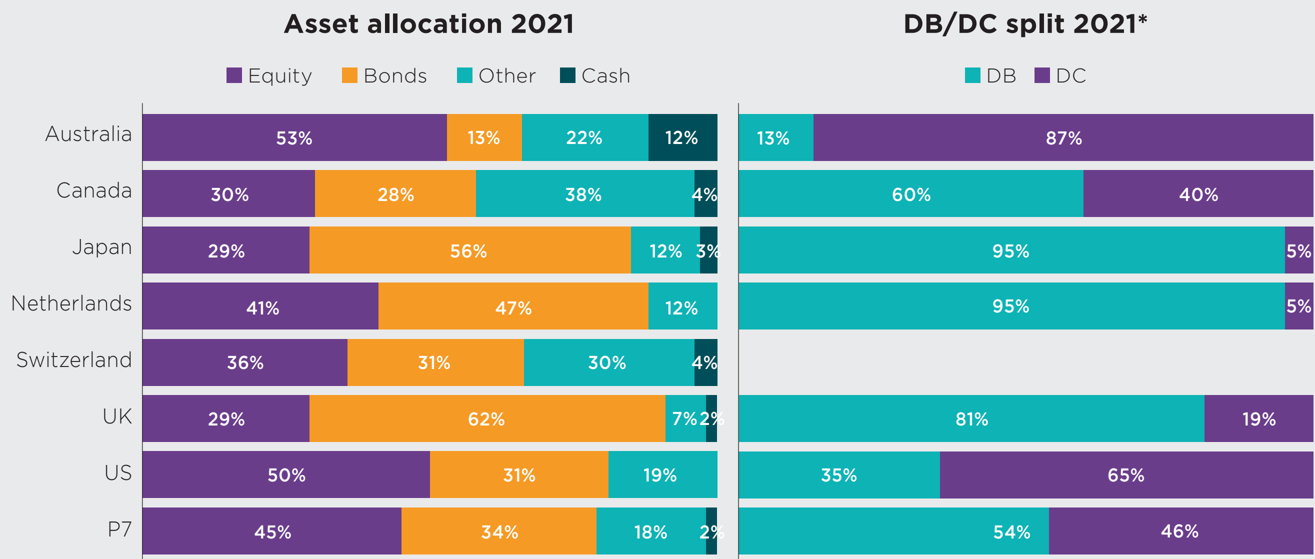
Fund managers need to decide what poses the greater danger – the risk of capital loss or the operational risk posed by illiquidity. They can learn from certain notable examples.

Australia's pension assets, for example, have consistently seen the biggest annual growth, according to the *Global pensions assets study 2022* by the Thinking Ahead Institute, founded by WTW, formerly Willis Towers Watson. It says growth has averaged 11.3% over the past 20 years, and attributes this to "a competitive institutional model and the dominance of DC".

Notably, Australia's pension fund landscape has the highest equity allocation at 53%, nearly double the UK's 29%. Australia and the US also have a significantly higher DC weighting than other major economies.

So, would regulatory changes make UK pension funds turn away from bonds – and should they?

The UK government's recent consultation about investment in illiquid assets seems to indicate this, urging that



Source: Thinking Ahead Institute and secondary sources *P7 = world's seven biggest pension markets*

DC schemes and trustees consider diversifying their portfolios and exploring a range of assets "to reduce burdens on trustees and open up private markets further".

Christine Hallett, MD at independent pensions services provider Options UK, believes there's little appetite in the UK for divergence into higher-risk investments because, she says, regulators have stifled opportunity. "Some individuals who have the appetite and propensity to take more risk are deemed to be incapable of determining this themselves," she adds. "Even if investment regulations were relaxed, unless there is a change in approach from the regulators, pension professionals would still not embrace the change for fear of comeback."

The law changes may not quite bring a free-for-all. But Daniela Silcock, head of policy research at the UK's Pensions Policy Institute, believes regulation change can help Britain play catchup. She points to Australia as a positive example but notes that charges are much higher there, predicting that the UK will invest more in diverse portfolios while keeping charges low, "therefore moving ahead".

Global lessons

Diversification at scale within a single fund

Even with new freedoms, the UK may only match the power of, say, Australian funds if they define and approach diversification in the same way. "There's a tolerance to multiple accounts in the UK that we in Australia find hard to understand," says Dr Martin Fahy, CEO of the Association of Superannuation Funds of Australia (ASFA). "Diversification comes at scale within a fund, not through individuals having a proliferation of tiny amounts in pots."

The Australian DC market is based on what Martin describes as the three pillars of compulsion, universality, and preservation. And the asset allocation of the country's pension funds (see table, p.38) is part of a system more liquid than many people assume, says Martin.

One characteristic he highlights is the allocation to alternatives, particularly long-term infrastructure around the world, such as roads and airports, energy, and digital. These are all government-awarded utilities or monopoly assets but with built-in consumer price index increases over 40 years, aligning with the liability that the DC market has built across the system, he says.

Martin explains that this approach allows funds to capture an illiquidity premium in the asset in a low inflation environment. It also generates significant cash inflows, and investors benefit from exposure to long-term assets that they would find difficult to get through listed markets.

Similar to the Australian model, the New Zealand pension landscape is largely dominated by multi-asset funds, although, says Mark Hattersley CFP™ Chartered FCSI (Financial Planning), a financial planner based in Wellington, there are a small number of 'self-select' KiwiSaver and superannuation schemes that share some commonality to self-invested personal pensions.

"These are used by advisers as a conduit to meet their own asset allocation framework and fund selection and offer access to direct equities, investment trusts, active and passive pooled funds, all with a 'mainstream feel' to them rather than esoteric solutions," he says.

Venture capital funds

If the UK were to allow its pension funds to invest in venture capital (VC) funds, that would help to level the global playing field. VC, however, is a particularly illiquid asset class, so DC funds must factor in the risk of a flood of redemptions. Then there's the cost – the illiquidity premium – and the current 0.75% charge cap currently prevents making VC a worthwhile risk.

For all the potential return of a freer investment landscape, the risks have also been underlined recently. In June 2022, a historically high-returning Australia suffered a A$116bn stock market crash, driven by fears of recession, giving superannuation funds their biggest hit since the 2008 financial crisis.

Asset allocation and growth

One surprising legacy of the rule changes may be how quickly public pension plans embrace the new freedoms – certainly if trends follow the US, where riskier assets constitute a larger percentage of American public pension funds than private plans, according to a report from January 2019, *Impact of public sector assumed returns on investment choices*, by the Boston College Center for Retirement Research. It shows

>>

// THE LAW CHANGES MAY NOT QUITE BRING A FREE-FOR-ALL //

IMAGE: EVA BEE/IKON IMAGES

>> that in the 20 years before the report, both private and public plans had the same average allocation to fixed income, equities, and alternative asset classes. But over the preceding decade, public plan risk had been 10% higher because, it suggests, public plans benefit from a higher assumed rate of return.

In the UK, the compound annual growth rate for pension assets since 2011 has been 4.5%, according to the Thinking Ahead Institute. This suggests a need to embrace the opportunity regulatory change would bring.

Hong Kong in that same period shows CAGR of 9.4%. But its Mandatory Provident Fund – the country's compulsory occupational pension, with both the employee and employer contributing 5% – lost nearly a quarter of its value in 2022 because of sell-offs in equity markets.

// EASING RESTRICTIONS WOULD ALSO ENABLE FUNDS TO PURSUE A MORE VIGOROUS ESG AGENDA //

David Snelling, CEO of dual-registered Hong Kong and UK wealth management company Charlton House Wealth Management, believes Hong Kong could learn from the UK in terms of charges. "In Hong Kong you've got passive tracker funds where people pay 1% to track the market," he says. "In contrast, you invest in an exchange-traded fund in the UK and you're paying 0.1%. The transparency that came to the UK market in 2013 led to a tightening of investment costs, including pensions."

ESG agenda

Easing restrictions would also enable pension funds to pursue a more vigorous ESG agenda. A May 2022 Pensions and Lifetime Savings Association survey of 91 UK pension funds has found that 74% have net zero plans in place or planned within the next two years.

Close neighbours share the UK's goals too. Europe Capital Group's *ESG global study 2022* of 565 global institutional investors across 19 countries – nearly half of them pension fund managers – finds 31% of Europeans cite ESG as "central to our investment approach". In North America that figure is only 18%, and 22% in Asia Pacific.

A move towards more DC funds might tip this balance further. According to a March 2022 survey by Mercer, 38% of DC schemes include an ESG fund as a default and half have made such funds available to members who self-select. DB schemes are mostly invested in bonds and therefore have fewer ESG options.

Will pension funds seize the opportunity?

It remains to be seen whether any of these reforms will change pension funds' risk-return mindsets, and how the government will respond to the results of its consultation. If the 0.75% fee cap is scrapped, it's uncertain how many schemes would switch emphasis to illiquid assets. Many are keen to broaden their asset horizons, but the reforms may bring higher charges, potentially compromising funds' fiduciary duty to give their members value for money. Opening up illiquid asset investment could unleash a torrent of wealth into pension schemes – or could simply result in members paying more money for the privilege of risking their future retirement income. ●

Being an expert witness

EXPERT WITNESSES CAN EARN SUBSTANTIAL FEES AND ENHANCE THEIR CVs WITH THE EXPERIENCE THEY GAIN FROM WORKING WITH LAWYERS. **LAURA DEW** REPORTS

Expert witnesses can play a key role in determining the outcome of a court case, helping all parties to understand complex issues.

Whether acting in criminal or civil cases, they must have relevant expertise, be impartial and objective, and provide reliable evidence in their report, which will help the court form its conclusion.

It is up to the court to decide whether parties will be allocated expert witnesses, and the budget and quantity of these depends on the case size. Usually, each side will have them. Occasionally an expert witness will be appointed jointly by parties on both sides.

IMAGE: ISTOCK

Role of an expert witness

Duties will include meeting with lawyers, reading extensive evidence, formulating a legal report and, if necessary, being cross-examined in court. They may also meet with an expert witness for the opposing party to read each other's reports and work out where they agree and disagree.

There are two types of expert witness: those doing it as a one-off and those who do it professionally. However, those who have done it once can find themselves acting again as their prior experience makes them an attractive candidate.

Their duty is to the court, not to any of the involved parties. Therefore, they should remain independent and avoid being influenced by the party they are working for to reach a certain conclusion. A test of this is whether they would reach the same conclusion if instructed by a different party.

A witness may find out the verdict of the case afterwards and whether their

// EXPERT WITNESSES SHOULD REMAIN INDEPENDENT //

>>

>> evidence played a part, but this is not always guaranteed.

What to expect

In the first instance, an expert may be approached and interviewed to determine their suitability for a case and may be provided with explanatory documents. During this meeting or call, the candidate should ask questions to determine what work is involved, demonstrate their knowledge and expertise of the matter, and find out the issues on which evidence is required.

The chosen expert witness will receive a letter of instruction and a bundle of evidence to review as well as any additional material.

This will include written confirmation of the agreed fee and an estimate of the time required, plus any costs involved, such as travelling expenses. There are no prescribed charging rates for being a witness in the UK, so this would be decided between the witness and the party based on the difficulty and volume of work involved.

The expert produces a draft report based on their review of the evidence supplied and other documentation. This report is clarified and amended with input from the legal team.

Reports should include all points in the letter of instruction, raise potential additional points, have a robust and factual conclusion, and be grammatically correct.

If there are expert witnesses appointed for both sides, a joint report is produced based on each side's report, highlighting where the two agree and disagree.

// EXPERT WITNESSES MUST BE ABLE TO HANDLE PRESSURE //

Work and time commitment

Paul Rex, managing director of GBRW Expert Witness, warns that anyone asked to act as an expert witness should not underestimate the work required and be flexible to meet the deadlines.

"The amount of work can vary enormously. The range can be between five and ten hours for small cases to 100 hours or more if it is a complex, high-value case."

But the attraction of acting as an expert witness, according to Paul, is the intellectual satisfaction of working with lawyers and experts and the interesting professional issues tackled, as well as the remuneration available.

However, being an expert witness is not without risk and they could fall foul of a complaint. These include failing to do a thorough examination of the documents, an insufficient report, straying beyond their expertise, or reaching a biased opinion. In the worst-case scenario, the expert witness could risk reputational and professional damage.

Training before a case

In financial cases, expert witnesses will often be required to go through large volumes of paperwork dealing with complex concepts. Their reports should distil these concepts into simple language as the judge may not have the same level of financial knowledge.

It is therefore important that anyone acting as an expert witness seeks training beforehand from independent firms to avoid making a costly mistake. While some lawyers offer training themselves, this is not always advisable as there is a risk of the solicitor unduly influencing them.

Mark Solon, founder of training company Bond Solon, says expert witnesses must be trained in essential areas such as how to prepare a court complaint report and what to include, the court rules and, importantly, how to be cross-examined in a courtroom, as this can be very challenging.

Mark adds: "The cross-examiner will question if the expert has the right qualifications and experience to give opinion evidence on the issues in dispute and whether the court report has been written correctly.

"In financial cases, the cross-examiner will use various methods to test the expert witness and may try to confuse the witness on technical matters. Sometimes this does not go down well with the judge as the primary duty of an expert is to assist the court to understand such technical matters."

Cross-examination can be stressful, so an expert witness must be able to handle pressure, says Paul Rex, and law firms face a risk when putting someone in the witness box as they do not know how a witness will react.

It is common for a cross-examiner to attempt to undermine the witness's character, experience, and qualifications to minimise the negative impact of the witness on their own client.

Despite the work involved in producing the report, more weight is typically given to the witness's performance in court.

Expert witnesses share their experiences

Shifting timescales

Robert Lockie CFP™ Chartered FCSI, branch principal and chartered wealth manager at Bloomsbury Wealth, was referred by a friend for expert witness work in November 2019.

"I thought it would be fairly easy to do it during work but it came at the same time as the year end. The market was plummeting, and the pandemic lockdown hit, so I had to do it in evenings and weekends instead. There were mountains of documents and it took a long time," said Rob.

He spent 169 hours in total on the case, which included 45 hours drafting the report, 72 reviewing and amending it, and 3 hours 40 minutes in court. The remaining time was spent on reading documents, conference calls, emails, a meeting with counsel, witness training, and travel to court. Robert negotiated an hourly rate and submitted monthly invoices and kept a detailed timesheet of his work, which made the payment easier.

He says that an expert witness should have the ability to review large volumes of data, have the attention to detail to identify inconsistencies, be able to communicate clearly, meet deadlines, and think under pressure.

Despite the workload, Robert is open to acting as an expert witness again and has since received two other offers.

Detailed research

Shannon Currie CFP™ Chartered MCSI, director at Perceptive Planning, has already acted in several cases, supporting expert witnesses in research and acting as one herself. This has mostly been on civil cases but she has also worked on a high-profile criminal case.

A notable aspect of the case was the long timescale as it related to matters that had occurred some ten years before, meaning she needed historical knowledge of the economic and regulatory environment prevailing at the time as well as current knowledge of the context.

One aspect she notes that helped her was having barristers as clients at her financial planning firm as she is familiar with how they communicate and act. "One needs to be very careful not to conflate what is a 'known fact' with opinion based on that fact. Your opinion and judgement are what you are hired

>>

TIMELINE OF ANDREW PAGE AND OTHERS V FINANCIAL CONDUCT AUTHORITY

May 2019 The FCA publishes decision notices regarding five individuals whom the FCA alleged had acted recklessly and dishonestly and provided false and/or misleading information. The individuals had formerly been directors at failed financial advice firms and provided unsuitable advice to over 2,000 customers. This advice caused them to move their pension benefits, via self-invested personal pensions (SIPPs), into high-risk financial products in which an unauthorised firm, which had referred the customers, had significant financial interest. The individuals applied to have the decision overturned at the Upper Tribunal.

November 2019 Robert Lockie receives his first contact regarding acting as an expert witness for the case.

December 2019 He receives confirmation that he will be acting for the FCA.

January 2020 He receives a document bundle of evidence, submitted by the five applicants, on which to base his report.

May 2020 He sends the draft report to the FCA's legal team for review and amendments.

September 2020 Following various delays on the part of the applicants, the final report is served to the court.

November 2021 Hearing begins and is scheduled to run for five weeks, although Lockie is only called to appear on one day.

May 2022 The Upper Tribunal court publishes its 300-page judgement ruling that the five individuals allowed their "instincts and values" to be "overridden" and their judgement to be compromised for personal financial gain. They also failed to scrutinise where their customers' pension funds were being invested. As a result, they were banned from working in financial services and fined over £1m. Three were subsequently (December 2022) disqualified from acting as company directors.

// AN INTERESTING EXPERIENCE //

>> for, but you need to be clear which is which. The difference between these may seem subtle to a layperson but not when conversing with a barrister and legal team!"

Multiple regulations

Ian Smith CFP™ Chartered FCSI (Financial Planning), director at Central Wealth Planning, said he found his time as an expert witness to be an "interesting experience" but the complexity of financial regulation made it difficult as the same areas were affected by multiple different regulations.

"The case was one of the largest fraud trials of the past decade to go to court but the defendant changed his mind and pleaded guilty," said Smith. "I do not know whether the evidence I provided affected that but I certainly questioned the viability of the proposed defence."

He received some training before the case and intends to do more in the future in case he is asked again.

Overall, the interviewees for this piece said they would be open to taking up the role again and had enjoyed the intellectual curiosity and satisfaction of the role, regardless of the monetary benefit. ●

INTERNATIONAL DIFFERENCES

Paul Rex, managing director of GBRW Expert Witness, says he quite frequently places expert witnesses in areas such as United Arab Emirates, Singapore, and Hong Kong, often in international banking cases. For example, an international bank which has made a loan to a multinational company, or a cross-border investment dispute.

In the Middle East, legal systems are based on Shariah law but international financial districts have commercial courts based on English common law. Expert witnesses are unable to comment on the local laws of the jurisdiction but can provide their international best practice.

India has a hybrid legal system which combines civil law, common law and religious law, according to Thomson Reuters Practical Law, and an expert witness's opinion only becomes admissible under cross-examination in court. "In some markets with a relatively small business community, for example in Asia, people sometimes don't want to give evidence as they don't want to upset business or social contacts. They also may not relish the prospect of being cross-examined in a public forum," says Paul.

Sri Lanka has acted to address such concerns. Party-appointed expert witnesses can be formally summoned by the court if their evidence will be beneficial to the party's case and the party applying must lodge payment to cover the witness' expenses. Alternatively, court-appointed experts can be commissioned on request and must provide impartial evidence.

In Spain, according to the European Expertise & Expert Institute, a change in 2000 saw the courts move from selecting experts themselves to having experts appointed by litigants at the time of the initial claim. Expert witnesses are chosen from a list and compete for the case based on their expertise. They must be able to defend their report under cross-examination, similar to the UK. However, unlike the UK, the decision over whether there is a need for an expert witness is decided by the lawyer rather than the judge.

The system in Spain allows those seeking such work to give just their official expert title, without any evidence of experience or specialty, meaning people can be eligible even if they have only worked in the field for a short time. This has created an excess of 'experts'. To reduce this, professional associations have been set up to defend experts' interests.

professional development

> Digital transformation is about changing the mindset of a business to digital by default

Ask the experts: Digital transformation means uniting all teams in a single vision
pp.50–51

Grey matters: Transfer authorised
pp.46–47

Continuing professional development
pp.48–49

Quick quiz answers: 1.A, 2.D, 3.B, 4.D

IMAGE: ISTOCK

Transfer authorised

THIS DILEMMA, UPDATED FOR 2023, WAS ORIGINALLY PUBLISHED IN THE JUNE 2012 EDITION OF *THE REVIEW* AS 'BONUS POINTS'. IT INCORPORATES THE THEMES OF CONFLICT OF INTEREST, RESPECTING OTHERS, AND SPEAKING UP

Ray has completed nearly a year of his first job in a small branch of a bank, which he joined straight from school. His recent appraisal says that he has performed well and shows great potential. Accordingly, he is not surprised to be told by the assistant manager that the branch manager, Christine, wishes to speak to him.

Christine congratulates Ray on his performance and says that although, as a rule, staff are not able to participate in the bank's bonus scheme until they have completed 12 months' service, Ray has done very well and she wants to encourage him. She hands him an envelope, saying that because of the special nature of the payment and the bank's rules on bonuses generally, he must ensure that he does not discuss it with anyone. Ray feels a little embarrassed to have been singled out but pleased to have made a good impression.

Ray enters the staff room where he opens the envelope and is pleasantly surprised to read that £500 has been transferred into his account. Christine includes a message saying that the bonus is her personal recognition of Ray's hard work and good performance. Ray is a bit surprised at the comment, which leaves him unsure whether the 'bonus' is from the bank or from Christine herself.

Although Christine has told Ray not to mention the award to anyone, which is the bank's normal rule regarding bonus payments, he feels unable to keep this to himself. On the way home, he texts his friend Dan, whom he had met on the bank's induction course, suggesting they meet later for a drink. Dan, who works in another branch but lives nearby, readily agrees.

Later that evening when Ray meets Dan, he says he's had some good fortune and offers to buy him a drink, "not just the usual pint, but anything you like". They order cocktails.

Dan asks what has prompted this unusual generosity and Ray says that he is not supposed to tell anyone, but he has received a bonus. Dan expresses surprise, saying that they don't qualify for the bank's bonus scheme and that staff have been warned that bonus payments will be very limited this year, so Ray getting one must surely be a mistake.

// HE WONDERS IF HE HAS DONE ANYTHING WRONG IN ACCEPTING THE MONEY //

IMAGE: ADOBESTOCK

Ray tells Dan that Christine had said that the bonus was personal. Despite Christine's warning, he shows Dan the letter. Dan reads it and says that he is very surprised, and it looks as though Christine has given Ray the money out of her own pocket. He says this is rather unusual and he hopes that Ray has not been asked to do anything unusual by Christine.

Dan says that the payment might also be against the bank's policy as it could imply all sorts of things but, even so, he is enjoying his drink bought with the proceeds of Ray's bonus. Ray says that he is sure that he has done nothing wrong and suggests that they talk about something else, and the conversation turns to less controversial matters.

At the end of the evening, they go their separate ways, not having said any more about Ray's bonus, but Ray awakes in the early hours and has difficulty going back to sleep. He wonders if he has done anything wrong in accepting the money or if anything he has done at work might have led to him getting the bonus, but he cannot think of anything.

Ray wonders if he should raise the matter with anyone in the branch, and if so, whom? He also wonders whether he should perhaps phone the helpline number that he was given on his induction, but he is unsure to whom he will be talking and if it will get back to Christine that he has called. That seems to be worse than doing nothing. In the end, Ray falls asleep with the matter unresolved.

What should Ray do?

A. Approach Christine directly to clarify the situation and return the bonus.
B. Notwithstanding that he has been told not to discuss it with anyone, Ray should report it to whoever is responsible for HR matters in the branch.
C. Call a staff helpline and raise the matter.
D. Do nothing. He was very fortunate to have received a bonus in these difficult times. ●

WHAT WOULD YOU DO?
Visit *cisi.org/transfer-authorised* to share your views. We will share the survey results and CISI's opinion at *cisi.org/verdict-transfer-authorised*

Test or release: The verdict

This Grey Matter, published in the September 2022 edition of *The Review* magazine, explores the pressures of a manager, Meena, dealing with a new starter, Hiromi, who is not performing to par and has recently disclosed that he may have ADHD.

After speaking with an external HR adviser, Meena offers Hiromi a formal assessment to better understand his needs, but he declines and the pressure on her to deliver is increasing.

What should Meena do next?

This dilemma was seen at the 2022 Annual Integrity Event, attended by around 1,200 in total (over 1,000 virtually and 160 in person) and the results are as follows:

1. Wait to find out if she gets the new job and then quit her current one and not worry about Hiromi. The culture of the company is not great, her line manager hasn't been very helpful, so maybe she should be the one to pick up the pieces. (4%)
2. Ask Hiromi for evidence of ADHD or insist that he is formally assessed and speak with HR again about what this could mean for his employment. She might have to keep him and recruit another person to support with the role or find him another role internally. This will upset her line manager and might affect her perception of her performance. (27%)
3. Raise the issue with a senior stakeholder at her organisation in the hope that they will provide better guidance than her line manager. She doesn't want to be seen as a weak leader, but her line manager was not helpful and her advice conflicts with HR's recommendations. (67%)
4. Take matters in her own hands and be as impartial as possible, not letting Hiromi's potential ADHD get in the way of the company's performance. This means transferring him to another department or terminating his employment, but this might have a detrimental impact on Hiromi's mental health. (2%)

Responses received: 601

The CISI verdict
The dilemma incorporates many themes from the CISI Code of Conduct, including professional development, awareness of capabilities, respecting others and the environment, and speaking up and listening up.

It also raises several concerns about the firm: poor company culture, poor internal processes, and insufficient management training.

Better internal processes may have made it easier for Meena to speak to her manager about the difficulties she was facing in her team and to receive the advice and support that would help her through the situation. And better managerial training would have helped Meena to speak with Hiromi and raise concerns about the quality of his work.

Our recommended solution is option 3: receiving a second opinion and getting better guidance on next steps would be helpful to Meena as she seems conflicted with the advice already received.

Should you wish to suggest a dilemma or topic to be featured in a future Grey Matter, please email *ethics@cisi.org*.

CONTINUING PROFESSIONAL DEVELOPMENT

WE HAVE AN EXTENSIVE LIBRARY OF CONTENT ON CISI TV AND YOUTUBE, AND OVER 200 ELEARNING MODULES IN MYCISI. HERE'S A SMALL SELECTION

Access all these CPD resources on our new app. Find out more at ***cisi.org/app***

Or access them on your desktop at ***cisi.org/MyCISI***

Or view some of them at ***cisi.org/youtube***

Learn

87%

of survey respondents rate the CISI CPD portal as very or somewhat valuable

CISI member survey 2022

PAKISTAN ANTI-MONEY LAUNDERING/ COUNTER-TERRORISM FINANCING

Course contents

- Definitions and terminology
- Pakistan legislation and regulation
- Global AML standards
- Identifying and responding to red flags
- Terrorist financing
- Suspicious activity reporting

CPD: 18 HOURS
PASS MARK 75%

cisi.org/pakistan-aml

£52 members
£62 non-members

JOINT FINANCIAL SECTOR DEEPENING AFRICA & CISI WEBINAR: UNDERSTANDING NATURE-RELATED RISKS AND OPPORTUNITIES

Dorothy Maseke, group head of risk and compliance, ICEA LION Group; Kelvin Massingham, director, risk, FSD Africa; and Jonathan Israel, senior programme manager, risk, FSD Africa, discuss the important link between nature and finance and why nature-related risk and opportunity management matters.

CPD: 75 MINUTES

#RISK

cisi.org/jointFSDA-CISI

LOG IN TO MYCISI FOR A WEALTH OF OPPORTUNITIES TO DEVELOP YOUR EXPERTISE THRO

MICROMODULE: CONSUMER DUTY

Our new micromodules give time-pressed professionals a whistlestop tour of a subject.

This micromodule comprises one video of six minutes' duration, explaining why Consumer Duty was introduced, what it aims to achieve, the three elements of the Duty, who the rules apply to, and what it means for firms.

CPD: 6 MINUTES

cisi.org/micro-consumer-duty

Events

I&M CAPITAL & CISI WEBINAR: STATE OF MARKETS – REVIEW AND OUTLOOK FOR 2023

Two experts discuss key financial market segments, reviewing 2022 and looking at forecasts for 2023

CPD: 77 MINUTES

#WEALTH MANAGEMENT

cisi.org/state-of-markets23

THE FINANCIAL PLANNING CONFERENCE 2023

10

hours of CPD

cisi.org/financialplanning23

#financialplanning23

This year's immersive event features three streams of content, with keynote sessions from a renowned psychiatrist, a 'fanatical' futurist, and an extreme adventurer, as well as from tech experts, financial planners, and many more.

Unwind over a guided tasting of locally produced wine and celebrate excellence at the Financial Planning Awards reception and dinner.

UGH ONLINE RESOURCES, EVENTS, AND PUBLICATIONS, AND DOCUMENT YOUR PROGRESS

Ask the experts: Digital transformation means uniting all teams in a single vision

Bharat Bhushan, partner and chief technology officer for KPMG, and **Jonathan Lister Parsons**, chief technology officer and co-founder of PensionBee, discuss effective communication for digital transformation

PART 1: FIVE THINGS YOUR TECH TEAM WANTS YOU TO KNOW

1. What you want and why you want it

BB: Digital transformation isn't about installing new tech toys in the organisation. It starts with being clear on your vision, purpose, and strategy at the top of your house. Then establish what enterprise and technology architecture you need to support it and map out the skills and talent taxonomy you need.

JLP: Digital transformation is about changing the mindset of a business to digital by default. The transformation is in the opportunities this brings for customer experience and engagement, products and services, operational effectiveness, and data-driven decision-making and capital allocation. Don't put technology on a pedestal. Recognise that the point of technology is to deliver something. Therefore, think of it as a facilitator.

2. What is possible

BB: Most organisations, particularly in the financial services sector, realise that cloud computing can enable business transformation. I see data analytics, artificial intelligence, and machine learning as part of that. For example, the move to Open Banking means that third parties can look at my financial data and predict the transactions with a high degree of accuracy and recommend changes that can help me to live a better economic life. Am I paying too much for my utility or subscription services, for example? There's a massive role for AI and machine learning in this space.

Other technologies are in the earlier stages of establishing themselves.
For example, financial institutions could use quantum computing for risk modelling, creating new products and services. Digital can bring greater maturity in self-service.

3. Why it's essential to comply with security legislation

JLP: Better security, including internationally recognised standards such as ISO 27001 certification, which demonstrates that your business has systems in place to protect corporate information and data, has helped with the adoption of cloud-based services. What's also helped is the EU's General Data Protection Regulation and the US's Health Insurance Portability and Accountability Act, which establishes national standards for protecting certain health information.

You need to cultivate a shared language"

Being incredibly careful about the security of the data and having that privacy overlay means there's control over what people can access and what rights people have to that data, which means you can build operational processes off the back of it.

For example, cloud providers can handle payments for you so that you, as the business, never need to take credit card details, enabling you to focus on products and services.

4. How to cultivate a shared language between teams

JLP: An ongoing challenge is to develop software and products in a genuinely collaborative way between the business and technical sides. You need to cultivate a shared language. What doesn't work is when your business analysts write a requirements document using words like 'orders' and 'customers' that make sense to them, then the technical people look at it and put together a technical requirements document. It doesn't have any of the words in it, and it doesn't make any sense to the businesspeople. So, they've got no way of evaluating whether the thing being designed will solve the problem. You need a shared vocabulary where the technology people learn about the business. That's a challenge. Domain-driven design, which matches software taxonomy with input from business experts, helps with that, but it's not as big as some other philosophies, like agile, for example, which talks about collaboration.

Digital infrastructure; what is it and how will it benefit consumers? Experts discuss digital infrastructure and transformation in our webinar held in August 2022. Watch to earn 65 minutes' CPD. *cisi.org/infrastructure*

5. The importance of establishing new ways of working

BB: Since the pandemic, there's a realisation that technology is no longer a department that sits 'over there'. The tech team is an integral part of the firm. It enables the organisation to serve its customers and provides differentiation in the market. Often, you hear the word 'agile' concerning the technology team. I think tech teams would want the organisation to realise this isn't just about agility in working with technology. It's about business agility.

PART 2: FIVE THINGS YOU NEED TO TELL YOUR TECH TEAM

1. Where you want to be three years from now

BB: Once you're clear on where the company wants to be and who you want to serve, you can start setting a digital transformation roadmap, not just for today but for the next three years. As a developer, I perhaps didn't appreciate the business direction. All I cared about was whether I could write the most efficient code with the least defects and help technical engineers who have only looked at tech to understand the business drivers and angles.

2. What makes you unique

BB: Increasingly, it is becoming harder for firms to create unique selling points from products alone due to commoditisation. The differentiation is created in customers' emotional experience and connection with the product and/or the firm. Businesses that approach digital transformation holistically consider the user (consumer, colleague, and partner) experience, operating model, distribution strategy, processes, technology architecture, and partnerships. They then use technology to realise these human-centric experiences across channels. Digital interactions generate data and the ability to observe behaviours and create a feedback loop to learn and enhance products. Key performance indicators also change in the digital world – both for business and IT. For example, measuring number and quality of interactions over average number of products sold, customer net promotor score, and sentiment improvement over time.

> **"You need clear communication from the management team"**

JLP: You need clear communication from the management team to the rest of the company about culture, strategy, and behaviours. This helps all departments to understand who the firm is and what is expected from each team. For example, if outstanding customer service and simplicity are core values, then someone sitting in the tech team will know they need to build a simple product that provides excellent customer service. Then, if a firm is unsure which direction to go in, they can refer to the values and consider how to do it more simply.

3. Who your customers are

JLP: The tech team needs to know about customers' needs in all their nuance, as they are building technology to satisfy those needs. In a sense, this is the heart of good product management. Technologists also need to understand customers' behaviours and preferences. It allows them to effectively hypothesise how to meet a customer's needs through a digital service and then measure whether that need is satisfied. Digital transformation makes it much easier for a business to provide this information, as real-time feedback and behavioural analysis tools stream data directly to the teams building the technology. In return, there is a tighter feedback loop between the tech team and the business's customers, accelerating innovation relative to more manual processes for aggregating customer feedback.

4. What your priorities are

BB: A common design language is critical in communicating prioritisation with clarity. The mechanics of achieving prioritisation may be based on a business case, feasibility, business outcomes, risk impact, alignment to strategy, and user feedback.

Communication is often through daily meetings, updating the backlogs and making decisions visible to all through prioritisation grids and collaboration tools.

This clarity helps teams/squads/individuals prioritise their time. For example, developers in the team will write code to deliver a feature aligned to that prioritisation and their business counterpart will validate and test it.

A perfectly formed squad often contains business analysts, developers, and testers that are always fully aligned with priorities.

JLP: Prioritisation within a digital transformation strategy is no different from any other business decision-making process. A digital transformation provides highly scalable foundations for extracting value over many years. The calculations about return on investment are different for more traditional projects. A business should be mindful of strategically valuable, foundational work and show a tech team that it values this technical capability building alongside the day-to-day work of evolving its products.

5. What resources are available

BB: It's essential to be clear about how you'll fund digital transformation. Is it a centralised or a decentralised budget? Consider the talent or upskilling needed, because managing emerging technologies in the cloud, for example, is very different from operating data centres. You'll need continuous training to get people up to speed on technology transformation. ●

New mentoring platform for all CISI members

Join today and learn
from, or support,
other members in our
professional community

cisi.org/mentoring

education

How cloudy is the fintech future? p.60

IMAGE: ISTOCK

REGULATORY UPDATE

Topics discussed:

p.54 Consumer reform

p.55 Drivers of change

Future scrutiny of financial services

Proactive, not reactive

p.56 Go long!

Regulatory consistency

p.57 Is the financial ombudsman taking the same approach?

How is corporate crime law and regulation changing?

REVIEW OF FINANCIAL MARKETS

58 ***The wealth of nations: building sustainable finance capacity***
Introduction by George Littlejohn MCSI, senior adviser to the CISI

59 ***Sustainable finance: the world in 2023***
Chris Hayward, policy chair at the City of London Corporation, on challenges that the UK is facing

60 ***How cloudy is the fintech future?***
Tim Skeet looks at where the relationship between technology and banking is headed, and how cryptocurrency has grabbed the headlines

61 ***Liability-driven investment: the final round-up***
Dr Iain Clacher and Dr Con Keating look at lessons learned from recent gilt market disruption

67 ***Plugging the regulatory gaps to keep pensions safer in future crises***
House of Lords' findings on liability-driven investment

68 ***Debating the Economics of Financial Technology Conference, 21-23 June 2023***
Edinburgh University hosts the event, looking at the application of technology to finance

69 ***Corporate ego***
A book written by former Scottish banker Sir Ewan Brown has sparked a debate on the role of corporate governance

LAST WORD

70 ***Base rates jumping***
As interest rates surge from their ultra-low base of recent years, Andrew Davis looks at the effects

REGULATORY UPDATE

ROBBIE CONSTANCE, PARTNER, AND CARYS THOMPSON, TRAINEE SOLICITOR, AT DWF OUTLINE KEY REGULATORY DEVELOPMENTS (UP TO NOVEMBER 2022).

ROBBIE.CONSTANCE@DWF.LAW

CARYS.THOMPSON@DWF.LAW

On the horizon, casting its shadow over all the regulatory updates we will discuss in this article, is the Financial Services and Markets Bill, introduced to parliament in 2022. The Bill seems poised to usher in significant regulatory initiatives, such as revoking retained EU law, establishing a framework for the designation of critical third parties, and providing the regulators with a secondary objective to advance long-term economic growth.

The future of financial services regulation looks to be focusing on substantive results and good outcomes rather than strict black letter law. The FCA is looking at ways to reduce harm down avenues other than enforcement, using data to head off risks of harm before they manifest. The most prominent manifestation of this is in the new Consumer Duty, which comes into force this year. Where enforcement does occur, redress schemes are often favoured over fines.

Outside the FCA, the Treasury and Prudential Regulation Authority (PRA) have been discussing the desire to focus financial services regulation on medium-to-long-term growth rather than 'quick fixes'. The chancellor announced new banking reforms in December 2022 aimed at enabling an agile and innovative approach to financial services. Finally, the Law Commission reports that it will be focusing on 'failure to prevent' offences, joining other regulators in the common cause of substantive results and good outcomes.

> // THE FCA IS CHANGING THE WAY IT APPROACHES ENFORCEMENT //

CONSUMER REFORM

By now, we are hopefully all familiar with the Consumer Duty. The FCA's new approach has started to take shape, with the first deadline requiring firms to agree implementation plans by 31 October 2022 and inform the FCA about them. Firms now have until 31 July 2023 to implement the new rules for all new and existing products and services, with closed book products business having until 31 July 2024. While the main focus of the Duty and its 'outcomes' is on fair value, timely consumer information, and customer service, we feel that the new duty to notify is deserving of close attention.

The FCA has introduced a new 'duty to notify' in the final Policy Statement (22/9) which requires firms to notify the FCA if they become aware that another firm in the distribution chain is not complying with the Duty. We're yet to see how this will play out, but it appears the FCA may be responding to criticism of its slow reaction and processing times, by 'outsourcing' an element of regulatory supervision and enforcement to all firms.

The FCA is continuing to emphasise the support needed for customers in vulnerable circumstances, and has

engaged with firms who don't meet the standards expected, particularly in other sub-sectors like credit and insurance where the cost-of-living crisis has the biggest impact on consumers. The FCA encourages using management information, considering customer needs in product design, having clear lines of accountability for senior leaders, and focusing on vulnerability training.

For updates on the duty, please see our Consumer Duty 'hub': Consumer Duty - an overview | DWF Group.

Compliance Forum - FCA key areas of focus for firms in 2023
David Raw, director of cross cutting policy and strategy at the FCA, talks about Consumer Duty and other regulation.
cisi.org/cf-consumer-duty

DRIVERS OF CHANGE

The FCA is not just creating new regulations, it is changing the way it currently approaches enforcement. In October 2022 it released a report on its progress with its Consumer Investments Strategy, one year on from its launch. It reports that restrictions were placed on twice as many firms in the investment market compared with 2020; 17 firms and 7 individuals were denied authorisation following suspected phoenixing; and 16 'contracts for difference' providers had their operations stopped, (apparently) preventing consumer losses of around £100m a year. The FCA also published 40% more consumer alerts than in 2021. The message from the FCA appears to be that it is prepped, armed, and ready to make a difference to consumers.

In parallel, the FCA's enforcement teams are following the lead of FCA supervisors by focusing more on redress schemes that compensate consumers, than on fines for the relevant firms. The FCA will give preference to creditors (some of whom may be consumers), ahead of its financial penalty, to maximise funds available for redress. We saw this in practice in the £2.4m fine for Pembrokeshire Mortgage Centre in November, compared with compensation payments to consumers of £13.3m.

The FCA issued guidance in July 2022 (FG22/4) on its approach to compromises by regulated firms. The guidance covers schemes of arrangement, restructuring plans, and voluntary arrangements. The FCA will take into consideration whether the compromise is the best possible outcome, the nature and scale of any misconduct, the effect on customers' FSCS compensation rights, and how much is being put into the compensation 'pot' by the firm. Compromises may (and often do) extinguish a customer's rights to bring a claim against the firm through the courts. The FCA is balancing this carefully against the merits of compromises, which often are a last resort before a firm involves an insolvency procedure.

FUTURE SCRUTINY OF FINANCIAL SERVICES

As the new Bill shows, regulatory scrutiny has significantly shifted from EU institutions to the UK and its regulators. The House of Commons Treasury Committee has established a sub-committee to carry out its new designated regulatory scrutiny role, previously carried out by the European Parliament. The new sub-committee on financial services regulations will have the power to "send for persons, papers and records" and report to the full committee. It will focus on regulatory proposals and intervene early on, at consultation stage. It will mainly be assessing whether the regulator is acting within its remit and whether the policy is justified. The desire is that the new processes will be less bureaucratic and more nimble, allowing for better outcomes for UK institutions.

// THE NEW CONSUMER DUTY TO NOTIFY IS DESERVING OF CLOSE ATTENTION //

UK Chancellor Jeremy Hunt's 'Edinburgh reforms' are similarly aimed at building an agile rule book for UK financial services regulation. Hunt's statements cover every element of financial services and their future regulation within the UK. He discussed the Bill and how he has lain before Parliament new remit letters for the FCA and PRA which further support the aim for a new secondary objective for both regulators. It is clear that the government's focus is on growth and achieving that through substantive results-driven policies.

PROACTIVE, NOT REACTIVE

Therese Chambers, director of consumer investments at the FCA, spoke in November 2022 of the intentional shift for the FCA from reactive work to proactive. This is evident, among other things, from its new cancellation and variation power. It updated its handbook rules in May 2022 to enable it to act quicker in cancelling permissions that aren't used or needed. Previously it needed to wait for firms to apply to remove their statutory permissions, but the new powers allow it unilaterally to remove permissions without consent where the firm in question is no longer carrying out the regulated activities for which it originally requested permissions. The FCA must send warnings to the firm before it uses this power.

Another tool to enable proactivity is the FCA's new data strategy. It is using social media and online information to spot potentials for harm. Chambers said the FCA is scanning 100,000 websites daily to identify potential

scams. It is also collating liquidity data to monitor risks of firm failure, while taking advantage of the vast amount of data available and using it for analytics, which undoubtedly will drive strategy going forwards.

Additionally, the FCA has, in conjunction with the Bank of England and the PRA, proposed enhanced powers to strengthen the resilience of critical third parties. The proposals, which are now included in the Bill, include a framework to identify potential critical third parties, implement minimum resilience standards for them, and develop tools to test the services provided.

Finally, the FCA, along with the PRA and Bank of England, is seeking feedback on the potential benefits and risks related to the use of artificial intelligence (AI) in financial services. It is looking into how the current regulatory framework applies to AI and whether additional clarification of existing regulation may be helpful. It will be interesting to see how the FCA approaches AI in the future and whether it will factor it into its new results-based approach to regulation.

GO LONG!

The Bill will bring to life recommendations by the Treasury Committee. These recommendations centre on the desire for financial services regulation, in particular from the FCA and PRA, to have as their secondary objective the goal of promoting long-term economic growth. Desperation for international competitiveness should not be allowed to weaken the UK's high regulatory standards. Regulators everywhere will be glad that clause 24 of the Bill includes this objective, to see the government protecting high regulatory standards and approaching regulation through a long-term lens.

REGULATORY CONSISTENCY

As well as the big picture developments, the FCA has introduced a number of consultation papers and policy papers relating to investment business consistent with overall strategic objectives.

EQUITY MARKETS

The FCA wants to improve how equity markets operate, by amending provisions that impose compliance and costs without demonstrable benefits. In CP22/12, it has proposed reforms which would "lower the cost of reporting for firms, improve post-trade transparency" and remove restrictions which limit "the ability of UK trading venues to compete with other markets". The FCA is focusing long term on financial resilience.

FINANCIAL PROMOTIONS

In accordance with its consumer investment strategy, the FCA has reformed high risk investment promotion through PS22/10. With increased online marketing of these investments, the FCA is concerned customers are not appreciating the specific risks of products, and instead are just 'clicking through' and accessing investments without much pause. Better checks may now need to be carried out to ensure that retail consumers' risk appetite is well matched to the product profiles for direct offer financial promotions. Firms must also be clearer on risks to consumers along the journey, work on client categorisation, and review appropriateness tests. 'Refer a friend' bonuses and other inducements to invest are now banned. This will also be reflected in the Bill.

APPOINTED REPRESENTATIVES (ARs)

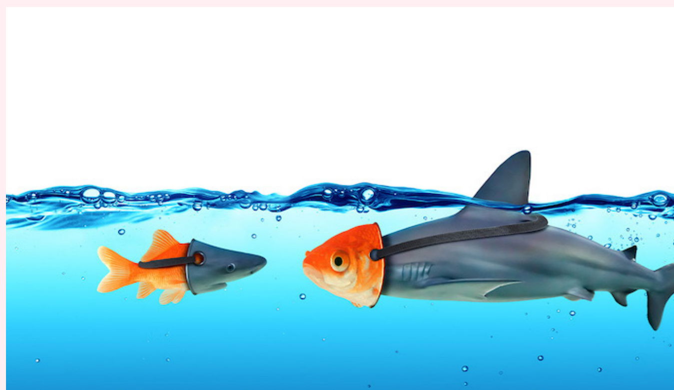
Policy Statement 22/11 focuses on the AR regime and implements new rules for principal firms. The FCA has identified a need for clearer rules to mitigate the risk of ARs mis-selling or misleading consumers, in part through inadequate oversight by their principals. Therefore, the new rules increase the onus of principals for appropriate supervision of their ARs. These rules include ensuring adequate systems, controls, and resources are in place, assessing and monitoring risks ARs pose in a similar way as principals do for their own business, reviewing ARs' activities annually, having clear criteria for when to terminate an AR relationship, and notifying the FCA of upcoming AR appointments 30 calendar days before they take effect.

> // THE FCA IS USING SOCIAL MEDIA AND ONLINE INFORMATION TO SPOT POTENTIALS FOR HARM //

This requirement for prior notification is perhaps most significant because it is a step towards the FCA looking more at the AR's approval substantively, rather than relying mostly on the principal to conduct all relevant assessments of suitability and due diligence.

CONSUMER ADVERTISING

Consistent with the forthcoming 'consumer understanding' outcome under Consumer Duty, as well as financial promotion reforms, the FCA is also focusing on how firms communicate. CP22/20 on sustainability disclosure requirements (SDRs) and investment labels highlights the FCA's concerns that firms are 'greenwashing' their products, which may be eroding trust in the market for



Compliance Forum: The fraud landscape in an uncertain world, and what to do about it
Panelists discuss fraud trends and practical takeaways. *cisi.org/fraud-landscape*

sustainable investment products. The FCA's proposals include:

- Classifying and labelling products as different sustainability classes based on FCA definitions, and monitoring the use of sustainable investment labels to assess whether they are meeting the FCA's criteria.
- Consumer friendly, accessible disclosures including objectives, investment approach, and performance against the objective.
- More granular disclosures at product and entity level.
- A general anti-greenwashing marketing ruling, and restriction on sustainability terms in naming and marketing of products.
- Requirements for distributors of in-scope investment products to make the sustainable investment label and disclosures available to investors.

IS THE FINANCIAL OMBUDSMAN TAKING THE SAME APPROACH?

The Financial Ombudsman Service (FOS) has expressed on its blog support for the new Consumer Duty and all its ramifications, saying "it sets higher and clearer standards of consumer protection across financial services. … We welcome the publication of the new Consumer Duty and the expectations it sets for the standard of care that financial services firms give consumers." It has said that it is working closely with the FCA to make sure their approaches are aligned. While the FOS intends to take the same approach as the FCA, an increased focus on consumer outcomes and new, potential vague standards by which to assess firms' conduct could well lead to unexpected and inconsistent outcomes. These cannot be fully assessed until the FOS's approach is established.

HOW IS CORPORATE CRIME LAW AND REGULATION CHANGING?

The drive towards individual accountability continues across the regulated sector, and the Ministry of Justice (MoJ) is no exception when it comes to criminal responsibility. The MoJ recently conducted a post-legislative assessment of the Fraud Act 2006 and concluded that despite the difficulties in enforcing fraud causes, the Fraud Act is sufficiently broad to catch the various forms that fraud may take and adapt to new technologies. It also considered sentencing guidelines and decided the maximum sentencing for the Fraud Act and sentencing guidelines are perhaps out of kilter with similar offences such as money laundering. The ministry suggests this is an area that could be reviewed.

Similarly, the Law Commission has conducted a review of the law on corporate criminal liability. It presented options to the government for strengthening the law by reference to current issues. Officials have experienced difficulties in holding individuals to account when decision-making is often dispersed within companies. The options proposed include new offences of 'failure to prevent', imposing liability on corporations that would previously have been too diffuse to attract individual liability, on the premise that the company should have had sufficient controls in place to prevent such acts or omissions. Another proposal is to facilitate conduct being attributed to a corporation if the action has stemmed from senior management. There is no certainty yet as to how many, if any, of these proposed reforms will be adopted. The commission states that one of its aims with these proposals is to make sure that strengthening the law does not overburden businesses, and does not increase the administrative process for lawful businesses. Here we can see once again the desire to strike a balance that delivers good outcomes by rethinking regulation.

***DWF**, Editors, CISI Regulatory Update*

Views expressed in this article are those of the authors alone and do not necessarily represent the views of the CISI.

Navigating the world of Fintech

Fintech has transformed the financial landscape in recent years, dramatically changing the way consumers access and use services and products. The breadth of fintech solutions only continues to grow.

cisi.org/fintech

THE WEALTH OF NATIONS: BUILDING SUSTAINABLE FINANCE CAPACITY

Climate change and sustainability are two key issues of our time. They present significant financial risks to business and society, and offer opportunities to lead the transition to a sustainable, low-carbon world, and at the same time to protect our all-important natural capital – the one world we have to live on (at least for now). Governments around the world (including the UK) are reviewing their sustainable finance strategies. To support that urgent process, the Chartered Body Alliance – the CISI with our colleagues, the bankers and insurers – working with PwC has been conducting research and analysis on behalf of the Green Finance Education Charter (GFEC) bodies on the knowledge and skills requirements in this central field.

The UK government launched the GFEC in 2020, a collective initiative across UK finance professions to align professional education and training with national and global sustainability objectives. This research programme, conducted in association with the main UK government departments, has identified current gaps and future knowledge and skills needs related to sustainable finance across the financial sector. The aim is to map the landscape, drawing attention to strengths, weaknesses, and gaps, benchmarking best practice globally.

The research will be published in March 2023, and indicates significant gaps in skills and training provision for our sector and a particular need for formal training plans for sustainable finance, including assessments of current knowledge and skills gaps in firms and individuals. This needs a combination of effort, and more joined-up thinking, both internally in organisations and externally through professional bodies, training providers, and government departments.

That needs careful thought on bridging the gap between knowledge and skills. Take, for instance, the voluntary carbon market launched in 2022 by London Stock Exchange Group (LSEG, where life on CISI began). Companies must demonstrate credible science-based strategies to reduce the carbon footprint of their activities to address unavoidable and residual emissions on their decarbonisation journey. Many companies are buying carbon credits as interim emission reduction targets are approaching. Corporate demand for these credits is sharply on the rise.

As in any market, there is a clear requirement for scale, liquidity, and transparency. In response, LSEG has launched its voluntary carbon market. It is designed to channel finance into projects that are seeking to reduce greenhouse gases in the atmosphere, giving rise to carbon credits, provide access to carbon credits for investors and corporates, and all with the benefits of public market regulation and disclosure requirements.

How will the voluntary carbon market work? That's where both knowledge, and skills, and the bridge linking the two, come in. The market is open to closed-ended investment funds and operating companies admitted or seeking admission to trading on the LSEG markets. A fund or a company raises capital from investors for a fund. The capital raised will be invested into a portfolio of climate change mitigation projects alongside other climate-aligned assets. Projects are managed by expert project developers and accredited by recognised industry bodies, with the objective of generating carbon credits that can be distributed to investors, retired on behalf of investors, or sold, leveraging the market infrastructure, regulation, discipline, and transparency inherent in public markets. The development of both knowledge and skills required here is becoming clear.

See CISI TV for Sustainable Finance: The World in 2023, our first programme for the new year, featuring the City of London's policy chair (next article) and Katya Gorbatiouk, head of investment funds at the stock exchange and the brains behind the new market, bringing that very knowledge, and the related skills, to our members.

SUSTAINABLE FINANCE: THE WORLD IN 2023

AT THE CISI'S FIRST EVENT OF 2023, CHRIS HAYWARD, POLICY CHAIR OF THE CITY OF LONDON CORPORATION, OFFERED A TOUR D'HORIZON OF THE CHALLENGES WE FACE

Collectively, markets from London to Los Angeles, Singapore to San Francisco, need better transparency, comparability, and credibility in the sustainable finance agenda. We need to position the UK as a one-stop shop: the go-to partner for countries and companies looking for capital and expertise, to help them meet their sustainability goals.

The City Corporation is working to facilitate this shift because it knows that sustainable finance is one of the best tools available to policymakers in the urgent race to meet climate targets.

Looking back on the world in 2022, it was unquestionably a year of challenge and change. The economy struggled to cope with successive crises precipitated by Russia's illegal invasion of Ukraine, post-pandemic supply chain shocks, and political upheaval just a couple of miles away in Westminster. Earth continued to warm with disastrous consequences for humans and animals alike. Mass flooding devastated 33 million people in Pakistan, while the western United States experienced severe droughts, and the United Kingdom's average temperature passed the 10°C threshold for the first time in recorded history.

These aren't the records to which we should be aspiring. It's no surprise that the Collins Dictionary's word of the year for 2022 was 'permacrisis'. But this suggests that we are resigned to the status quo, that our problems are entrenched, that we find ourselves in a hole so deep that it is inescapable.

We must not accept that defeatism. Collectively, just as humans have been the problem, so too we can and must be the solution. That starts with shifting the paradigm that has held sway for too long: that finance and sustainability are unrelated at best and opposing forces at their worst. The Green Horizon Summit at COP26 in Glasgow, our own Net Zero Delivery Summit in May 2022, and the launch of the Glasgow Financial Alliance for Net Zero (GFANZ) showcased that finance and sustainability are connected. Green action can lie at the heart of financial services, and financial services can lie at the heart of green action.

I realise that 2022 provided immense challenges to the sustainable finance agenda. The war in Ukraine prompted discussions in some quarters of retrenching to outdated, carbon-intensive fuel sources. Such short-termism would only saddle future generations with a planetary debt that they would struggle to repay. Together, we must ensure that we keep our eyes fixed beyond the immediate horizon, rather than looking down at our feet.

That means looking for global solutions to this global problem. We need a four-pronged approach.

First, we need to reduce frictions. This means strengthening UK policy and regulation with an effective and coherent sustainable finance framework. Second, we need to nurture innovation. More creativity in the market will create better products for green and impact finance and services from the UK. Third, we need to attract capital, firms, and exports. With better products for the market, we then need the customers to ensure a greater uptake of green and impact finance and services from the UK to the world. And fourth, we need to retain size and scale, encouraging firms to prioritise strategic skills planning to enable effective engagement with the sustainable growth markets of today and tomorrow.

The City Corporation supports the International Regulatory Strategy Group, which is providing the joint secretariat with the International Capital Market Association for a new industry working group with a mandate from the FCA to develop a voluntary code of conduct for ESG data and rating providers. The group met for the first time in December 2022 and will produce a Code of Conduct by June 2023. A comprehensive, proportionate, and globally consistent voluntary Code of Conduct for ESG ratings and data will help ensure the market is fit for purpose, supporting practitioners to assess risk more accurately. It is a valuable opportunity to contribute to the sustainable finance regulatory agenda as the UK becomes the second country in the world to develop a code of conduct for ESG ratings.

The City Corporation is also harnessing the powers of its brand and reach to lead the debate on the wider challenges the net zero imperative presents. Having previously identified that the 'COP circuit' lacked a defined mid-point, an opportunity for business to look both back and forward, we stepped into that void. In 2022, the City Corporation hosted the inaugural Net Zero Delivery Summit together with the UK COP presidency and GFANZ. That summit brought together nearly 200 international guests, including prominent business and public sector leaders in climate finance, such as Special Presidential Envoy on Climate John Kerry, COP26 President Alok Sharma, and GFANZ Co-chair Mark Carney.

FOCUS ON DELIVERY

On 24 May 2023, we will host our second Net Zero Delivery Summit at the Mansion House in partnership with the Egyptian COP27 presidency. This year's focus will be on delivery, promoting examples of best practice from the different sub-sectors of financial services in emerging markets, so that no community, no city, and no country is left behind.

We know that sustainable finance is one of the best tools available to policymakers in the urgent race to meet climate targets. We also understand that good growth and good regulation are two sides of the same coin. If we make sustainable finance an integral cog in the engine of our economic system, we will have more enduring, less harmful growth that is better for the bottom line and better for the planet. This year is our chance to convert green soundbites of aspiration into a symphony of action, and to convert the fear of 'permacrisis' into the hope of 'permachange'.

HOW CLOUDY IS THE FINTECH FUTURE?

TIM SKEET, A VETERAN BANKER IN THE CITY OF LONDON, SURVEYS THE PROSPECTS FOR 'FINTECH' AS IT SHOWS SIGNS OF LOSING SOME OF ITS ALLURE

Tim writes in a personal capacity. He is a career banker in the City, currently serves on the Executive Management Committee of Bank of China, London branch, and is Junior Warden of the Worshipful Company of International Bankers.

timskeet1@gmail.com

The history of banking and tech has not been a good one. The relationship between conventional finance and technology and its fintech sector has been difficult, confusing, indeed fraught. There are many reasons for this awkward relationship. Lack of mutual understanding across the technology divide is only part of the issue. The financial services sector is caught between dealing with its rickety tech past and being challenged to embrace a shimmering tech future. This can be an uncomfortable place to be.

On the fintech side, the term covers a multitude of diverse services from crypto to various software applications or online banking. Some parts of the sector were designed to challenge, disrupt, and eventually replace conventional finance, although this bit of the plan does not appear to have worked out well, at least so far. Where does the relationship between tech and banking go from here? A string of high-profile failures and PR disasters has pushed banking management to address some of the industry's pressing tech-related issues. There has been accelerated investment in and rebuilding of some of the dodgy old systems in the hope that they will prove more robust in future. Patching up old and outdated systems is no longer enough.

There is also acknowledgment that penny-pinching in IT can be a mistake, after past experiments in offshoring, outsourcing, and underinvesting. Those lessons have generally been learned and boards along with banking regulators no longer accept the idea that IT is an arm's-length black box. Tech is an integral part of a bank's operations and front-and-centre to the customer's experience. But banks will need to consider carefully how to economically adopt and adapt new technology to fit their existing IT infrastructure.

If banking is under pressure to clean up its act, a string of recent scandals and failures in the fintech sector has reminded us all why we have regulators and their rules in the first place. Much of recent tech headline-grabbing has been in the not-so-niche crypto market, a sector ripe for a regulatory overhaul. Crypto is a sector deliberately built around an attempt to recreate financial services without banks and their associated regulatory framework. The broader question for regulators, beyond working out what to do about crypto, is how to go about dealing with those other unregulated parts of the fintech industry that overlap with banking.

> // A BETTER UNDERSTANDING OF THE RISKS AND REGULATORY NEEDS ON BOTH SIDES OF THE BANKING-TECH DIALOGUE WILL OFFER A WAY FORWARD //

CROSS-BORDER REGULATORY RESPONSE

The regulators have, like the rest of us, been on a steep learning curve. It also remains unclear how the global regulatory apparatus will respond in this age of deglobalisation, protectionism, and geopolitical tension. Modern tech, just as financial services, is global and cross-border in nature. Will the regulatory response manage a suitably cross-border approach to tech, as was achieved for the banking industry following the 2008 crisis? Even as bankers and their regulators wise up to technology and its challenges, the banking industry is still faced with grappling with future tech needs and the 'solutions' on offer that might or might not live up to their ever-expansive promises. Tech decisions can be a very expensive and risky business.

To illustrate the nature of the debate, a recent banking industry discussion of the potential for using cloud-based services highlighted some of the problems. On paper, cloud computing offers great potential for efficiency and streamlining certain services and data processing. There were three broad conclusions from the discussion. The first focused on concerns over the costly nature of employing cloud-based processes on the scale required. Then there were worries over security and data control, and finally concerns over probable regulatory resistance. These discussions all contributed to what one newspaper recently referred to as the cooling of 'big tech's hottest growth market'.

A TOUGH FUTURE

However well thought out, much of today's fintech sector is also having to face up to some other recent and pressing concerns. Crashing equity market valuations for tech stocks, a shortage of capital, lack of revenues, and struggles to scale up operations point to a tough immediate future. It is not clear who will survive and flourish, as wannabe disrupters find themselves now disrupted. It should probably now seem clear that banks need technology, and the new tech operators need banks. Both sides also need a more comprehensive, well-thought-out regulatory framework. This should call for open minds and a good understanding of the issues.

There remain significant risks and expenses for banks as they approach unavoidable IT and tech decisions. The industry is right to proceed with caution. Perhaps a better understanding of the risks and regulatory needs on both sides of the banking-tech dialogue will offer a way forward pointing to opportunities for those companies with ideas that the banks can use. We just need to understand how to navigate our way through the clouds of confusion.

LIABILITY-DRIVEN INVESTMENT – THE FINAL ROUNDUP

BRITAIN'S GILT MARKET DRAMA IN SEPTEMBER 2022 DROVE DOWN THE VALUE OF RETIREMENT SCHEMES BY AS MUCH AS £500 BILLION. WHAT LESSONS WERE LEARNED?

Dr Iain Clacher and Dr Con Keating, long-time contributors to the CISI's thought leadership in the worlds of fixed income and pensions, were at the heart of the drama that stemmed from the then UK government's ill-fated economic policies under its short-lived prime minister Liz Truss. In this major contribution to our thinking on retirement provision, they analyse the fault lines in long-accepted funding arrangements.

Dr Iain Clacher is professor of pensions and finance and Pro Dean International at the University of Leeds.
I.Clacher@leeds.ac.uk

Dr Con Keating is head of research at Brighton Rock Group and a long-time member of the CISI Bond Forum Committee
con2.keating@brightonrockgroup.co.uk

Liability-driven investment (LDI) has become the catchall, portmanteau expression for a wide range of defined benefit (DB) pension scheme investment strategies, with the only-too-predictable result of confusion and even deliberate misrepresentation. In this article, we shall endeavour to disentangle some of the intertwined threads of different strategies and the arguments revolving around them.

MATCHING

The practice of buying bonds to match the contracted or projected future payment obligations of a company is as old as the hills. A portfolio constructed to achieve this objective is sufficiently commonplace that the technique has acquired a name – 'dedication'.

In the early 1980s, the high levels of interest rates prevailing in the international bond markets saw much activity from companies looking to retire their old low coupon outstanding issues, which were trading at very deep discounts to par value in the markets. It was simply not possible just to buy these bonds in markets as trading was rather thin. One contributor to this thinness was that many holders were constrained by the prevailing accounting standards from selling, as the realisation of prices lower than their book values would result in charges to the holder's profit and loss account.

The technique of dedication involved no more than buying a portfolio of government securities, usually strips,[1] whose contractual payments matched those due under the company's outstanding bond. The company would then place the securities bought into an escrow account from which funds could only be withdrawn to meet the company's specific payment obligations under the bond's indenture.

The motivation for the company to do this was firstly that this arrangement offered after-tax returns which were competitive and often superior to the returns available to them from further investment in their business activities. The question of realisation of the profits from these operations in the company's accounts, over time or in a single lump sum, seemed to lie entirely at the discretion of the company's auditors, and it was this discretion that provided secondary motivation. Once these arrangements were completed, the outstanding company bond issue ceased to appear in published company accounts. The process had also acquired a name – 'defeasement'.[2]

Over time, the range of securities that might be used to offset a company's bond obligations was in practice widened to include agency securities and even high credit quality corporate bonds. The limits of which securities were and were not suitable lay again at the auditor's discretion.

The widening of the range of securities employed brought with it the risk of default by the obligor, and with that failure to match cash flows. In 1975 even the possibility of default by the UK on its sterling debt obligations (gilts) was being openly discussed in the international bond markets. Some high-grade sterling-denominated corporate and multilateral development bank bonds traded at persistently lower yields than gilts.

The overarching problem with this pairing of security and debt obligation was its cost; it was expensive to acquire the matching portfolio.

In recent times, the Boots Pension Scheme has acquired the (unwarranted) status of posterchild for matching using government bonds to meet pension obligations and is often cited as an early example of matching LDI. In 2001/02 the Boots Pension Scheme sold its diversified portfolio of assets and was, according to legend, invested solely in gilts. In fact, derivatives were used to 'match' some index-linked characteristics, and that takes the strategy into a different and riskier class of LDI. Nonetheless, the cost of implementing the strategy became obvious and in 2007, Boots's new private equity owners, Kohlberg Kravis & Roberts, had to agree to pay £418m in deficit repair contributions[3] (over ten years) to plug what was then described by commentators as "the retail and pharmaceutical group's pension hole", just six years after the gilts switch. By 2010, the Boots schemes had closed even to future accrual.

> // THE BOOTS PENSION SCHEME IS OFTEN CITED AS AN EARLY EXAMPLE OF MATCHING LDI //

There is an important shift to consider when moving from the defeasance of corporate debt obligations, where these obligations are

[1] *Even though strips and zero-coupon government bonds did not gain widespread usage until the early 1980s, the use of depositary receipts as claims on specific coupons or principal amounts of government securities was quite common, for example, in the syndicate accounts within the Lloyd's American Trust Fund.*

[2] *See: OECD Glossary of Statistical Terms - Defeasement Definition*

[3] *Source: 'KKR agrees deal with Boots' pensioners' Financial Times, 19 June 2007.*

known with certainty, to the matching of pension obligations whose future values are uncertain in term and amount, and may only be estimated, using actuarial techniques.

The Pensions Regulator (TPR) is prone to describe LDI in these simple matching terms,[4] a practice we consider misleading, but the reality is that most LDI does not have this form, objective, or even motivation.

Holding to account: analysis and resolution of a crisis
Con Keating and Iain Clacher discuss the cause of market turbulence and present a solution in *The Review* article at *cisi.org/giltmarket*

CHANGING TIMES

Changes to accounting standards in the early 2000s drew attention to a company's pension scheme in annual reports. These standards used market prices (or close proxy arrangements) to value the assets in a scheme's fund, and present values of the projected pension payments to scheme members as the estimated current value of liabilities. It is worth noting that the standards are mixed attribute in nature.

On the asset side, the use of market prices to value assets has long been criticised as it is obvious that portfolios of the magnitude of pension fund asset holdings could not be realised at such prices, but as that is not typically a required operation, it has become custom and practice within the industry to value assets in this way as if they are readily tradeable and such values could be realised. However, the recent gilt market turmoil has shown this price and market capacity/depth issue to be a concern once again. There have been reports that some illiquid private investment structures traded at prices as low as 40% of their year-end valuations.

While on the liability side, the use of market-based yields to discount liabilities introduces a sensitivity error in the present values derived from those present in market prices. If we have an observation error of 1% in our asset price, the error in valuation is 1%, but if we have a 1% error in the observation of our market-based discount rate, the error in valuation is no longer 1%. With market yields at 10%, a 1% error in observation produces a near doubling of the error in valuation of liabilities for a typical pension scheme.

Among the changes introduced by the changes to accounting standards in the early 2000s was the reporting of scheme deficits in the accounts of the scheme sponsor company. The treatment of surpluses is asymmetric; only the amount of surplus, which may be readily refunded to the sponsor company, is allowed to be reported. The return of any surplus to sponsor is also subject to tax, currently set at a rate of 35%. When combined with the use of a market-based discount rate which introduced and magnified the trend and volatility of market rates into the valuation of scheme liabilities, this provided motivation for schemes to hedge the scheme's liability valuations. It is important to recognise that this is not the matching of benefits payable with asset cash flows, but rather the matching of changes in asset values with changes in the estimated present value of projected liabilities.

While this process may involve eliminating or mitigating many or all of the factors whose variation influences the projected values of liabilities, such as longevity and inflation, we shall focus solely on the largest, the choice of discount rate employed in the estimation of the present value of pension scheme liabilities. This is also the only factor which is not a determinant of the ultimate benefits payable, and as such it is not a risk of those benefits. This raises a question which has passed without discussion: trustees' responsibilities lie with the benefits ultimately payable rather than their intermediate valuation, and in this context, actions taken to manipulate these intermediate liability valuations may be beyond their powers, that is ultra vires.

> // TRUSTEES' RESPONSIBILITIES LIE WITH THE BENEFITS ULTIMATELY PAYABLE RATHER THAN THEIR INTERMEDIATE VALUATION //

IMMUNISATION

The technique used for the matching of hedging interest rate sensitivities is known as 'immunisation'.[5] The first-order measure used within this technique is the modified duration,[6] which, as it is mathematically the tangent of the price/yield curve, is only accurate locally, that is to say, it is only valid for very small changes in the yield or discount rate.

Duration is the local rate of change of the price/yield curve. The second-order measure, which captures the rate of change of duration, is known as convexity.[7] Hedging using these techniques requires periodic adjustment of the amounts of assets held in order to

[4]See for example, Neil Bull's testimony to the House of Lords Industry and Regulator's Committee on 14 November 2022.

[5]https://www.investopedia.com/terms/i/immunization.asp

[6]https://www.investopedia.com/terms/m/modifiedduration.asp

[7]https://www.investopedia.com/terms/c/convexity.asp

maintain the accuracy of the hedge. It is, however, significantly less costly to implement than the strategy of dedication, which does match, and continues to match through time, the duration and convexity of assets and liabilities.

Duration is a measure of the term of a sequence of cash flows; in the case where the discount rate is set to zero, it is simply the average life of the sequence. There are also estimation problems for the duration of non-gilt securities. Durations may even be derived for equities (students are often surprised that this is usually relatively short – between eight and 12 years). The market yields of these non-gilt securities reflect not just the time value of money, but also the specific default and other idiosyncratic risks, such as the security's liquidity. Duration, measured without correction for these factors, will understate the riskiness of the security as interest rate sensitivity.

Hedging of the valuation uncertainty could in theory take place in either scheme or the sponsor, but we have not encountered any case where the hedging has been undertaken within the sponsor. There is, of course, a reason for this, which is that TPR can and will insist on additional contributions being made by the sponsor when the scheme is reporting valuation deficits. There are also further differences between the statutory valuation requirements of schemes and their equivalent sponsor accounting requirements, most notably that scheme accounts should be prudently based, using assumptions and discount rates which are prudently based, while sponsor accounts should be based on best estimates of those values.

The Pensions Regulator appears married to interest rate sensitivities and is promoting the use of duration as a measure of scheme maturity, with 12 years being the trigger threshold for action in the proposed new DB Funding Regulations and associated Code, when in reality the average life of the scheme would be more intuitive, more predictable, and stable. To highlight this, there was a single day during the gilt market turmoil when the modified duration of the UK DB sector varied by over 12%, more than two years in term. During that day, the present value of UK DB liabilities varied by £181bn – to offer this a sense of scale, the total UK national tax receipts for 2021–22 were £718bn; the variation was equivalent to 25% of total annual tax receipts.

FUNDING RATIO

The funding ratio is the most commonly used and cited measure of the financial health or sufficiency of the scheme. It is simply the ratio of the value of the scheme's assets to the present value of scheme liabilities. As we have not seen the theoretical statistical properties of this ratio described elsewhere, we provide these in Box 1.

> // SCHEMES CURRENTLY OWN FEWER ASSETS BY VALUE FROM WHICH THEY WILL HAVE TO PAY PENSIONS WHICH ARE BASICALLY UNCHANGED //

The funding ratio is often presented as if it is a settled and certain fact, when it should in fact be treated as the estimate it is, and good practice would require its confidence intervals to be shown alongside its estimated value.

Under normal market volatility conditions, for a fully funded scheme, the one standard deviation confidence interval ranges from 96.2% to 104.1%. Under the market conditions seen recently, that confidence interval has expanded, ranging from 89.1% to 112.6%. These values have been estimated by simulation from empirical data on intraday prices and yields. There are very few, if any, schemes employing LDI with improvements large enough to qualify as statistically significant; there are many not employing LDI where the improvements are statistically significant.

Many of the advocates for the widespread continuance of LDI, including TPR, have been quick to point to the sector-wide improvement in the estimated funding ratio of DB schemes overall. The majority of this improvement will have been delivered by schemes not employing LDI. None of it should have been delivered by schemes employing LDI fully, as that was by design intended to eliminate both positive and negative variations in valuations.

The most elementary analysis of the crisis tells us that schemes now have far fewer assets than at the beginning of the year. Simply put, schemes currently own fewer assets by value from which they will have to pay pensions which are basically unchanged.

Common sense tells us that a greater reliance on uncertain future returns is riskier, but the modified duration, which will have fallen with rising interest rates, suggests that the assets and liabilities have a shorter modified duration and are less volatile or risky. It is also far from certain that the expected returns from assets held will warrant the use of the higher gilt yields as the scheme discount rate, given the various sales and other actions taken to meet collateral calls. In distress, these sales included the high-growth, high-return assets of schemes, and this was done without any true regard for their return prospects.

BOX 1: STATISTICAL PROPERTIES OF THE FUNDING RATIO

To model the funding ratio **(r)** analytically, we begin by considering both assets **(A)** and liabilities **(L)** to be lognormally distributed.

The variance is then just the sum of the two original variances, so if the ratio is r and r = A/L,

$$\mathrm{Var}(\log(r)) = \mathrm{Var}(\log(A)) + \mathrm{Var}(\log(L))$$

The means should just be the difference of logs:

$$E(\log(r)) = E(\log(A)) - E(\log(L))$$

THE SPONSOR COMPANY

The hedging being undertaken considers only the assets and liabilities of the scheme, even though the scheme has recourse to the sponsor in the event of shortfall. The sponsor, in its business activities, has exposure to many of the same risk factors as are considered in the scheme context.

For example, most companies prosper as interest rates fall and this constitutes a natural offset of some or all of the discount rate exposure of a DB scheme. There are similar relations arising from the limited price inflation of DB scheme benefits, and of course, the presence of a larger population of pensioners consuming but not producing carries opportunities and benefits for most companies. It is clear that any economically justified hedging would not follow the partial consideration of the scheme alone, but rather it would be concerned with the sponsor and scheme combined – their net exposures.

Given TPR's fervent desire to eliminate any reliance of a scheme on its sponsor company, we can only hope that the incongruity of their recent advice on LDI to trustees, on the agreement of standby lines of credit with sponsors for use in times of market distress, struck them as much as it did us. The specific advice commences with: "Schemes may prefer to establish a line of credit with their sponsoring employer to ensure liquidity."

This emphasis on scheme funding, once expressed as 'funding trumps covenant', is the cause of much excess and unnecessary expense for schemes and their sponsors. In effect, this is considering the fund alone as meeting the promise made by the sponsor, rather than the fund defraying the sponsor's costs of production of the promise made. Using market-based discount rates for the valuation further distorts the valuation; this is the current cost of replacing the benefits promised using market assets rather than the cost of producing the benefits as originally promised by the sponsor employer.

The fund's value as security for members in the event of sponsor insolvency was always secondary and has been further reduced in relevance by the introduction of the Pension Protection Fund (PPF).

THE PENSIONS REGULATOR

TPR has, in its statutory obligation to protect the Pension Protection Fund, an incentive to consider only the level of scheme funding. Its obligation to consider corporate growth prospects has been relegated to trustees. The obligation to protect the PPF also provides an incentive for TPR to promote and encourage the use of market-based discount rates. This in effect is estimating the cost of producing the projected promised benefits today, though these benefits were promised previously on different terms by the sponsor employer through time. TPR has been an avid supporter and zealous promoter of LDI strategies in all its forms.

> // THERE CAN BE SOME PROFOUNDLY UNDESIRABLE CHARACTERISTICS TO REPOS AND DERIVATIVES //

This amounts to the promotion of riskier investment asset allocations. For a scheme in deficit, for the assets to match the variability of liabilities, they must be riskier than those liabilities. If these assets are also to reduce the deficit, they must be riskier still. The promise of LDI was that this asset allocation strategy would do both.

The expense of LDI immunising portfolios reduced the expected returns of assets and raised the effective cost of provision for schemes, and that in turn led to the use of derivatives and repo. We have publicised our concerns over the lawfulness of schemes using repos and derivatives fully in our evidence submission to the parliamentary Work and Pensions Committee.[8] The authorities' response to the 2007–09 financial crisis, which saw short interest rates fall dramatically while gilt yields responded only slowly, provided the incentive for schemes to adopt leveraged LDI strategies en masse.

REPO AND DERIVATIVES

Setting aside our concerns over the lawfulness[9] of the use of repo and derivatives by schemes to leverage assets and hedge liabilities, there can be some profoundly undesirable characteristics to these instruments.

There are in essence two types of derivative: those which carry recourse for the counterparty to scheme assets, such as interest rate swaps, and those which don't, such as options (the right but not the obligation to undertake some activity). It is possible and indeed usual for derivatives to provide leverage, that is to have a small price relative to the notional amount of underlying asset exposure they control or reference. In fact, a fairly priced interest rate swap will have a price of zero at inception. In practice, there will be a price applied reflecting the counterparty's concern with their potential credit exposures over the life of the contract, a 'haircut'.

Non-recourse derivatives such as options may be highly leveraged, but as there is no further recourse to the scheme fund, the presence of leverage within them simply increases the riskiness and potential returns of the instrument. There are debates to be had over the suitability of the use of options within a prudently diversified portfolio of assets, but that debate would be institution specific. The fund's exposure is limited to the price initially paid for them, whereas it is the counterparties of the swaps and repos who would lose if a fund's net asset value became negative and the fund is wound up.

By contrast, derivatives such as interest rate swaps do offer the counterparty recourse to the fund's other assets; these take the form of collateral calls or variation margin on contracts outstanding. These calls reflect adverse variation in the price of the derivatives contract.

The standard risk management tools for financial contracts are initial and variation (or maintenance) margins. The initial margin is set to reflect the variability of the underlying asset and the variation margin reflects changes in the current price of the contract.

Similar risk management techniques are applied to repo transactions. These are agreements under which an asset is 'sold' to a counterparty for spot

[8] *See Clacher and Keating, Submission in Evidence to Work and Pensions Committee*

[9] *ibid*

settlement with this contract being accompanied by an agreement to repurchase the security at a future date at a higher price. The price differential is effectively the interest cost of borrowing the proceeds of the sale of the security. There is no doubt that a repo transaction is economically borrowing.

The terms covered by pension fund repo are mainly in the one-month to six-months range and occasionally for as long as one year – this is not short-term borrowing for liquidity purposes. The initial 'haircut' will reflect the volatility of the asset sold and agreed to be repurchased; a 2% haircut would simply mean that the fund receives 98% of the current market price of the asset. The variation margin reflects change in the credit exposure of the counterparty arising from changes in the market price of the asset under repo (relative to the contracted repurchase price) and the short rate for its remaining term. They are, in other words, mitigants of credit risk exposure.

Much of leveraged LDI is through pooled funds. These have limited liability for unit holders. They are also typically highly leveraged using repos and derivatives. In a 2019 survey, TPR reported fourfold leverage as the average. Any fund with this degree of leverage will be highly volatile – leverage simply magnifies the volatility of the underlying assets, while the manager has no enforceable call on unit holders. In times of adverse market developments, they may and do request additional subscriptions from existing unit holders for new units to be bought to recapitalise the fund and maintain the fund's prior properties, such as the level of leverage in the fund.

In the event of unit holders failing to comply with these requests, the managers will restructure the fund, selling assets and reducing indebtedness. Such restructuring in the recent crisis has been the cause of much dispute between unit holders and scheme managers, notably where the fund was de-levered, with the hedge provided being reduced or eliminated,

Anatomy of a bond crisis
On CISI TV, Con Keating discusses why pension funds destabilised markets in the latter part of 2022 *cisi.org/anatomy-crisis*

leaving unit holders exposed to the decline in gilt yields seen since the Bank of England's intervention. There are no reliable statistics on the overall magnitude of pooled LDI funds, but it seems likely that they account for at least £200bn of the £800bn total of pooled funds held by UK DB schemes, and that if leveraged fourfold, as reported by TPR, they control some £1tn of nominal gilt exposure, almost half the outstanding cash gilts in issuance.

It should also be recognised that any particular pooled fund manager will offer a wide range of funds with different characteristics, for example some funds may be confined to conventional gilt performance while others are concerned only with index- linked gilts, with further distinctions in the term of the maturity ranges a specific fund contains. This allows the pension scheme to pick and mix these funds so as to closely replicate the perceived exposures of the scheme.

// AT THE END OF 2022, UK PENSION SCHEMES CONTROLLED MORE GILTS THAN EXIST IN THE OVERALL CASH MARKET //

The Bank of England's conclusion that mismanaged leverage was the proximate cause of the gilt market disruption is undoubtedly correct. The more important issue, though, is the motivation for funds to indulge in LDI, and that we believe was primarily the elimination of valuation volatility, with a secondary objective, for some, to boost returns by leverage.

While pooled funds have been widely used by small schemes, there are many large funds which have used segregated mandates and/or self-managed portfolios. The Investment Association published an estimate that there were approximately £1.5tn notional interest rate swaps outstanding held by this group of schemes early in 2022. At year end, it is estimated that these schemes had borrowed some £200bn using repo and they held approximately £500bn of cash gilts. The totality of this is that UK pension schemes controlled more gilts than exist in the overall cash market, about 1.5 times as many.

This should not be a surprise. With the gilt market and the present value of DB liabilities similar in magnitude, and the durations of the gilt market and pension schemes respectively, say, 10 years and 20 years, then two 'gilt markets' are needed to hedge the pension liabilities if all are to be fully hedged. However, if only around 75% of schemes by value have hedged and they average around 80% coverage of their liabilities, then 1.2 gilt markets would be needed to hedge those covered liabilities.

We have seen this position before, where outstanding derivative exposures have been larger in amount than the underlying real assets. Those situations have rarely ended well – the 1987 US stock market crash induced by portfolio insurance was an early example, and the US mortgage securities crisis which developed into the Great Financial Crisis of 2007–09 is the most recent and largest.

It is important to recognise also that index-linked gilt (ILG) ownership is dominated by pension funds; they own well over 80% of all outstanding issued stock. The earliest ILGs were explicitly

targeted at pension funds.

Concentration of ownership is a well-understood issue in financial markets. It lies behind the 'free float' rules for listed equity. It is also well known in the trading behaviour of individual bonds; it is not uncommon for issues to be reopened in order to maintain or enhance the liquidity, that is tradability, of benchmark bonds. Securities whose ownership is concentrated are more volatile than would otherwise be the case; in extreme circumstances, idiosyncratic risks can become systemically critical.

GEMMs[10] reported turnover of £132bn in the week ending 23 September and £264bn in the week ending 30 September. This market turnover in the week ended 30 September approached 14% of the market value of all outstanding gilts, roughly twice the normal level of turnover. The one occasion when turnover of this level had been seen previously was March 2020 at the beginning of the pandemic.

CONTINUATION OF LDI

The advocates of the continuing use of leveraged LDI, and this includes TPR, have offered two main arguments in support of its continuing use, with only minor modifications such as overall leverage restrictions.

The first of these is that schemes should be explicitly permitted to borrow since all other large financial institutions and even individuals can do so. This ignores the fact that all other institutions have equity capital which supports their borrowing. The future earning potential of an individual is the equity capital which supports and services their mortgage debts. All that a pension scheme has is recourse to the capital of the sponsor employer, and the sponsor may borrow if it chooses to, and of course that borrowing will be tax-advantaged.

We have seen sponsor companies issue bonds where the proceeds were applied to the scheme and its pension fund. This is quite a common practice for state and municipal plans in the US.

The simple fact is that borrowing by a scheme raises the riskiness of the scheme and lowers the member security arising from the presence of the fund in the event of sponsor insolvency. These concerns were the motivation for the prohibition on scheme borrowing in the European IORP directive and its transposition into English law.

The second argument is that LDI has been beneficial for schemes. This assertion needs some unpacking. LDI as simple hedging of liability valuations should have been neither positive nor negative for schemes. Schemes which were less than 100% hedged will have profited, but that is scarcely an argument in favour of LDI. The argument reduces to that as schemes use leverage through derivatives and repo to minimise the cost of LDI hedging; this enables the fund to buy other higher-yielding, riskier growth assets. It follows that this beneficial argument is simply a statement that the speculation has been successful thus far. Borrowing at short rates to buy long-dated fixed-rate securities can be expected to be profitable as long as rates remain low and long-term rates decline. Of course, this ceased to be the case at the end of 2021 and this process simply accelerated through 2022 as concerns with increasing and persistent inflation have influenced market yields and central bank activity.

> // MANY OF OUR LONG-TERM STABLE INVESTMENT INSTITUTIONS HAVE BECOME CONCERNED AND DRIVEN BY SHORT-TERM LIQUIDITY ISSUES //

The Bank of England's QE portfolio, the Asset Purchase Fund, faces just this situation. The £800bn of assets bought were financed at the rate paid on commercial bank reserves, and over the period of the fund's existence it has contributed around £120bn to the Exchequer. However, with short rates now at 3%, the strategy is already cash flow negative, and its disposal is likely to realise substantial losses, perhaps larger than the earlier receipts.

We have also seen some official responses about what is required for the continuance of leveraged LDI, but they do not inspire confidence.

The statements from the Central Bank of Ireland and Luxembourg's CSSF that buffers need to be held at the levels of 300 to 400 basis points miss two points. The first is that assets will nonetheless need to be sold once the cash element of these buffers is exhausted, and these buffers will need to be replenished. It also completely fails to recognise that it was a two-day move of just 37 basis points which triggered the LDI liquidity spiral when buffers were reportedly set at 100 basis points. This is indicative of grossly inadequate risk modelling; the models in use are exercises in comparative statistics but the models needed are those based on the risk dynamics of these processes.

The statements offered by many that they were surprised by the speed and magnitude of the moves seen are recognition of the inadequacy of their existing risk management models and practices.

FINAL THOUGHTS

The most important problem though is that the use of these strategies and instruments has converted many of our long-term stable investment institutions, DB pension schemes and their funds, into bodies concerned and driven by short-term liquidity issues. Commercial banks have precisely this form of exposure. They borrow short and lend long, and the resultant maturity mismatch is subject to Pillar 2 regulatory capital 'add-ons', which most unusually are not made public.

We also have the issue that many schemes are seen as funded to 'buyout' or much closer to that position than ever expected in the near term. However, this misses a crucial point. The depth of the buyout market historically has been between £20bn and £30bn a year. If we even assume that the market was able to underwrite £75bn in 2022 – and let us be clear, insurers can pick what funds to transact with as it is a buyers' market – that still leaves the rest of the DB universe having to pay pensions in full, on time, as they fall due, with considerably fewer assets available to them to do so.

[10] *UK Debt Management Office GEMMs weekly gilt turnover report*

PLUGGING THE REGULATORY GAPS TO KEEP PENSIONS SAFER IN FUTURE CRISES

IN FEBRUARY 2023, THE HOUSE OF LORDS INDUSTRY AND REGULATORS COMMITTEE CRITICISED THE USE OF LIABILITY-DRIVEN INVESTMENT (LDI) STRATEGIES BY DEFINED BENEFIT PENSION FUNDS, RAISING CONCERNS THAT REGULATORS HAD NOT FOCUSED SUFFICIENTLY ON THE RISKS AND DANGERS THAT BORROWING TO BOOST INVESTMENT RETURNS COULD POSE TO PENSION SCHEME FINANCES, AND TO WIDER FINANCIAL STABILITY IN THE EVENT OF INTEREST RATES RISING

Key findings from the committee's scrutiny, during which it heard from industry and regulatory representatives, including Legal & General, the Financial Conduct Authority, The Pensions Regulator, and pensions experts, included:*

- LDI investment strategies, particularly those that use leverage, were created as a solution to an artificial problem created by accounting standards, which drive sponsoring companies to focus heavily on current, rather than long-term, estimates of pension deficits. Pension schemes aimed to hedge volatility in these estimates by investing in bonds, but due to the low returns these offered and the need to close their deficits, they borrowed to boost their returns.
- The use of borrowing and derivatives for these purposes is not permitted by the relevant underlying EU legislation, which appears to have been permissively transposed in the UK to allow pension schemes to continue using such strategies.
- It is likely some pension scheme trustees were not aware of the potential implications of their LDI strategies and their decision-making struggled to match the pace of markets. This has led them to become dependent on advice from investment consultants, whose advice to schemes is currently unregulated and may not be comprehensive over the whole portfolio or cover operational requirements.
- Despite calls for more information and a review of stress tests from the Financial Policy Committee, regulators in the sector appear to have been slow to recognise the systemic risks caused by the concentration of pension schemes' ownership of assets such as index-linked gilts, and the increasing use of more complex, bank-like strategies and instruments by pension funds.

THE RECOMMENDATIONS

The Lords committee calls for action to improve regulation and reduce the risk of similar disruption in the future. It recommends that:

- UK government and the Endorsement Board should review whether the current system of accounting for pension scheme finances in company accounts is appropriate and whether to introduce a system that does not drive short-termism in pensions investment. More schemes should be allowed to take an asset-based approach if this is appropriate for them.
- The government should review the relevant regulations and consider whether the use of repos and derivatives should be more tightly controlled and supervised in future. If schemes are to continue to use leveraged LDI, there should be far stricter limits and reporting on the amount of leverage allowed in LDI funds.
- The government should ensure that investment consultants are brought within the regulatory perimeter as a matter of urgency. Following this, regulators must have heed to the non-professional nature of trustees in their regulation of consultants and ensure consultants are liable for their advice. Regulators should ensure they have more information on the leverage present within pension scheme finances and that stress tests are conducted. The government should consider giving the Prudential Regulation Authority a role in overseeing pension schemes.
- The Pensions Regulator should be given a statutory duty or ministerial direction to consider the impacts of the pensions sector on the wider financial system. The Financial Policy Committee should continue to take the lead on systemic risks to financial stability and should be given the power to direct action by regulators in the pensions sector if they fail to take sufficient action to address risks.

The use of leverage and derivatives is key to considerations of the risks posed by LDI. The Pensions Regulator published a survey on DB pension scheme leverage and liquidity in 2019 which found that 45% of all schemes had increased their use of leverage over the past five years, accounting for 58% of scheme assets. The notional principal of schemes' leveraged investments totalled almost £500bn. The survey set out that the level of leverage ranged from 1x to 7x. Critics of LDI suggest that LDI funds, and particularly pooled funds which involve several small and medium-sized pension schemes, tend towards the higher end of that leverage, making them unstable and requiring only relatively small declines in price or yield to require high degrees of leverage to be unwound.

Lord Hollick, chair of the Industry and Regulators Committee, said:

> The evidence we heard overwhelmingly suggests that the use of LDI strategies caused the Bank of England intervention. If it were not for the use of leveraged LDI, then it is likely there would only have been some volatility and a market correction, rather than a downward spiral in government debt markets that threatened the UK's financial stability and led to significant losses as pension fund assets had to be sold in order to meet LDI liquidity requirements.
>
> The impacts of accounting standards and the widespread adoption of leveraged LDI have transformed pension schemes from being long-term institutions into ones focused mainly on short-term volatility in prices and interest rates.
>
> We are calling for regulators to introduce greater control and oversight of the use of borrowing in LDI strategies and for the government to assess whether the UK's accounting standards are appropriate for the long-term investment strategies that are expected of pension schemes. This will help ensure that the turbulence that followed the September 2022 fiscal statement doesn't happen again.

**Source: UK Parliament Committee report, 'Leveraged LDI strategies worsened September 2022 financial turmoil'*

DEBATING THE ECONOMICS OF FINANCIAL TECHNOLOGY CONFERENCE, 21–23 JUNE 2023

THE UNIVERSITY OF EDINBURGH TOGETHER WITH THE EDINBURGH FUTURES INSTITUTE IS BRINGING TOGETHER LEADING EXPERTS IN THE WORLD OF FINANCE AND TECHNOLOGY TO ASSESS THE NEXT PHASE IN THE APPLICATION OF TECHNOLOGY TO FINANCE

As rising consumer expectations continue to apply pressure on the financial services sector, digital transformation is now at the top of the list of strategic initiatives of every major financial services stakeholder, from companies to regulators and academics – and it is clear that the next major phase of the digital transformation of the sector is imminent. Research teams from world-leading universities and technology and financial services companies are working on exciting, under-the-radar technologies that will be at the heart of this transformation. The Economics of Financial Technology Conference, organised by the Edinburgh Futures Institute and the University of Edinburgh Business School, aims to give all stakeholders, in particular practitioners, a front-row seat to the work of these teams as it brings together academics, policymakers, and finance professionals to share new insights and discuss the critical issues related to the application of technology to the practice of finance in a rapidly evolving regulatory landscape.

Speakers and teams at the conference will present the latest research and insights driving new ideas and regulation, bringing together finance, technology, and policy. Among others, presentations will explore game-changing developments in artificial intelligence and machine learning, distributed ledger technologies, open banking and finance, robo-advising and the gamification of investment vehicles, peer-to-peer lending and crowdfunding markets, credit risk modelling, and regtech.

The three-day conference will include keynotes, panel discussions, and parallel sessions. Areas to be covered include theoretical and empirical contributions on topics including, but not limited to:

- the application of AI and machine learning in finance
- the application of distributed ledger technologies in finance
- cryptofinance
- cyber risk in finance
- the microstructure of modern financial markets: algorithmic/high-frequency trading, dark trading, blockchain settlements, and more
- behavioural economics in financial technology
- alternative data (structured and unstructured datasets)
- crowdsourcing and investment strategy
- new exchange traded financial derivatives
- financial stability risks from the development of fintech
- regtech
- open banking.

EDINBURGH MASTER'S STUDENT RESEARCH

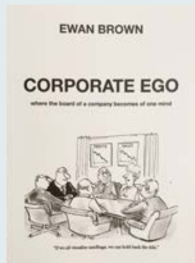
In parallel with this, the university runs a regular programme of engaging its master's students in industry research programmes. These are meant to address challenges or opportunities in a business that practitioners would be keen to have researched but don't have the time or resources. A finance master's student might be able to carry this out as part of their summer dissertation project.

Students carry out an in-depth research project as part of their programme, and the university welcomes project enquiries from industry practitioners so that students can apply their academic knowledge to a real-world business challenge. There is no charge and each student is supported by world-leading academics. The project would investigate a defined research area, and result in a substantial report (the student's MSc dissertation) with extensive research, analysis, and practical conclusions.

The students combine their strategic business and management skills and specialist knowledge with the refinement offered through the 12-month, intensive programmes they are following. Students come from a wide range of backgrounds, offering fresh, often international perspectives and ideas for your business.

CORPORATE EGO: FAILURES OF CORPORATE GOVERNANCE IN SCOTLAND AND BEYOND

SIR EWAN BROWN, DOYEN OF SCOTTISH BANKERS, AND WHO HAS SERVED ON THE BOARDS OF MUCH OF SCOTLAND PLC, SET THE CAT AMONGST THE PIGEONS IN DECEMBER 2021 WITH HIS BOOK CORPORATE EGO



Using seven once-prominent Scottish listed companies as examples, *Corporate Ego* postulates that the prime culprit for each company's fall from grace was the development of a collective mindset in the boardroom. Ten recommendations are offered to improve the workings of listed company boards and, thereby, reduce the risk of future corporate accidents.

That all seven companies were Scottish is incidental. The weaknesses that led to the failures of Burmah Oil, Lilley, Ivory and Sime, HBOS, RBS, Standard Life, and Johnston Press are generic. The equally dramatic collapses of Barings, Carillion, Patisserie Valerie, and Thomas Cook provide compelling evidence of this.

I received many constructive comments on the recommendations; and these were reflected in a supplement published in May 2022.

The modified recommendations are:

> Since it is within the boardroom that the role and influence of the chair is most discernible, but at the same time is not well understood, there should be an independent review initiated by the London Stock Exchange and the Financial Reporting Council into the role and effectiveness of the chairs of UK listed companies.
>
> Since the roles of chair and chief executive require very different skill sets, and to avert potential boardroom dominance, it should require shareholder approval for the chief executive of a UK listed company to become the chair.
>
> Directors must read and analyse the company's cash flow statement over time to determine the relationships between operating cash flow, borrowing, investment and dividends. Do this before looking at the profit and loss account and, where possible, convert operating cash flow into a rolling average to eliminate inevitable fluctuation and to determine a trend.
>
> Before the annual accounts of a UK listed company are finalised, the board should be required to approve a working capital statement prepared to the same standards as are required for a prospectus – and this should be reported on by the company's auditor.
>
> On each occasion that a UK listed company issues a statement or makes an announcement, including changes to board membership, the board should state there are no issues of which shareholders should be made aware that are not already in the market.
>
> To ensure that the views of employees are heard and taken account of in the boardroom, there should be at least two meetings each year between the non-executive directors and employee forums.
>
> The number of non-executive positions one person can hold in listed companies, wherever registered, should be no more than three. In evaluating board candidates, nomination committees should ask how much time they think it will take to do the job effectively.
>
> It should be a listing requirement that there is, at minimum, an annual meeting between the board of a UK listed company and the trustees of the company's defined benefits pension scheme.
>
> The criteria for recruitment of non-executives to the board of a UK listed company should be made public.
>
> Non-executive directors should ensure that where they have challenged or disagreed with a decision at a board meeting, there is a proper record of this in the minutes of the meeting.

I had thought that *Corporate Ego* and its recommendations would generate comments and suggestions from the chairs of Scotland's then 15 (now fewer) listed companies [excluding investment trusts]. However, there was no response from Abrdn, AG Barr, Aggreko, Cairn Energy, Devro, FirstGroup, John Menzies, Macfarlane Group, J Smart, SSE, STV, Weir Group, or Wood Group.

Although any change to corporate governance is a UK issue, a strong, coordinated voice from respected professional bodies and influential stakeholders might just resonate with policymakers and regulators. More than 30 listed companies have been lost to Scotland over the past four decades. They include Bells, Christian Salvesen, Dawson International, Distillers, General Accident, and United Biscuits. More recently, John Menzies and Stagecoach have been taken over and others are under threat.

It was put to me that:

> A contributory factor has been insularity, with Scottish boards and directors lacking experience of living and working outside Scotland and not having the breadth of perspective required to compete in ever evolving global markets. Too often, the same faces appeared on multiple Scottish boards and attended the same awards dinners and knew each other socially. This insularity and possible unwillingness to upset the apple cart may have induced an unconscious complacency into Scotland PLC over the years and a lack of non-executive knowledge and experience to challenge, for example, unwise international expansion.

Scotland can ill afford to lose so many substantial companies, some of international importance and all contributing strongly to local and regional communities. The fact that they disappeared, or were taken over, one at a time may explain why so little public concern about corporate decline has been expressed over the years. In proportion to the rest of the UK, they represent a cataclysmic loss of head office and corporate influence. Over the same timescale, more than a dozen prestigious mutual life assurance companies, headquartered in Scotland, also disappeared.

What will it take to get key stakeholders to engage, collectively, in strengthening board effectiveness and achieving better decision-taking across the private sector?

Sir Ewan Brown was an executive director of Noble Grossart, merchant bankers, for over 35 years, then became a non-executive director of Stagecoach Group, chair of James Walker (Leith), a board member of Entrepreneurial Scotland, and a trustee of the Royal Scottish Academy Foundation. Past directorships have also included Scottish Financial Enterprise (chair), Lloyds TSB Scotland (chair), Lloyds TSB Group, Wood Group, Scottish Widows Bank, Pict Petroleum, Scottish Transport Group and Scottish Development Finance.

Andrew Davis
@andy_davis01

LAST WORD

Base rates jumping

AFTER ALMOST 14 YEARS OF ULTRA-LOW INTEREST RATES, THE TIDE HAS TURNED AND THEY ARE ONCE AGAIN ON A FIRMLY UPWARD PATH, FUNDAMENTALLY ALTERING THE GLOBAL FINANCIAL LANDSCAPE IN WHICH INVESTORS OPERATE

In February 2023 the Bank of England increased the base rate to 4%, which compares with just 0.1% just over a year earlier. That same month, the US Fed funds rate rose to 4.5-4.75%, compared with around zero in the first quarter of 2022, and the ECB raised its three key rates again.

Base rates directly influence the yields on government bonds, which in effect provide the yardstick by which most other assets are valued. They play a foundational role in the financial world. The change in direction therefore has major implications across the board and will touch every part of the financial system, affecting organisations of all sorts.

It would be impossible to produce a comprehensive list of the changes that rising base rates will bring in their wake, but we can readily identify some of them with reasonable confidence.

For more than 30 years, a steady decline in global interest rates – sometimes blamed on a glut of savings, especially in Asia and the Middle East – has caused a worsening headache for so-called final salary pension schemes in developed economies. These schemes pay their members a guaranteed retirement income funded largely from the yield schemes receive on their bond investments. As bond yields fell, deficits opened up between the income the schemes were forecast to receive and the amounts they would have to pay out in future pensions. These deficits are calculated using government bond yields among other inputs, so falling yields mean bigger deficits and rising yields tend to close the gap.

As interest rates have headed back up over the past year or so, the deficits on these pension schemes have in many cases disappeared, putting the pensions of millions of workers on a much sounder footing. This will come as a huge relief to many older workers who are members of these schemes, but will offer cold comfort to their younger colleagues. Faced with yawning deficits in their final salary pension schemes over the past two decades, caused by ultra-low interest rates, most companies closed them to new members. This summarily denied younger workers the safety in retirement that their parents' generation was guaranteed. Will these 'gold-plated pensions' make a comeback now that rates are returning to more normal levels? Don't hold your breath.

> **High interest rates will spell trouble for companies that depend on cheap borrowing to survive**

Back in the days when base rates were well above zero and government bonds offered meaningful income, many investors favoured the so-called balanced portfolio, which combined equities and bonds in a classic 60/40 blend. The theory was that the two assets tended to balance each other out, with bonds doing well when equities struggled and vice versa. This worked especially well when bond yields were solidly positive because investors could get paid a decent income for holding bonds, while also benefiting from the 'insurance' they offered against falling equity markets. But with bond yields at zero or lower, the theory no longer worked as well, and bonds lost one of their key attractions as an investment – steady income. Now that yields are rising again, it is possible the 60/40 balanced portfolio will stage a comeback.

A third inevitable effect of higher interest rates is that unicorns – privately-owned start-ups that achieve a valuation of US$1bn or more – will become rarer. These formerly mythical beasts proliferated during the era of ultra-low rates as investors took on more risk in search of higher returns. But with rates rising and capital therefore more costly, investors will be more careful about how they allocate it, in particular becoming choosier about funding risky, speculative ventures at extraordinary valuations. Achieving unicorn status is likely to get a lot harder, and entrepreneurs that have big dreams but burn through cash year after year will find the going extremely tough.

Does the same go for cryptocurrencies? I suspect not. The urge to speculate will never die and crypto's one undoubted strength is as a vehicle for unfettered 24/7 speculation.

Finally, and most obviously, high interest rates will spell trouble for companies that depend on cheap borrowing to survive. For years, there have been complaints that ultra-low interest rates were artificially prolonging the life of over-indebted 'zombie' companies and so blocking the fundamental capitalist process of creative destruction, whereby resources are released from failed companies for use by others that can generate higher returns from them. Rising rates are likely to speed the demise of the zombies and create new opportunities for others. Messy and painful though it is, creative destruction is an essential element of a capitalist system. As long as our societies continue to espouse versions of capitalism, it will, for better and worse, be part of our lives. ●

ILLUSTRATION: PADDY MILLS/SYNERGY

THE FINANCIAL PLANNING CONFERENCE 2023

3 - 4 October
Wotton House, Surrey

Early bird prices and an **extra £100 off** for CFP™ professional members until 14 April

Join us for our flagship financial planning event

Our annual conference provides a unique opportunity to step back from the everyday, and to reconnect with fellow financial planners to learn, share and debate all things financial planning.

The programme has been created by financial planners, for financial planners, providing ideas and new perspectives that can be implemented to strengthen your business and client experience.

- ✓ Earn 10 CPD hours, with three content streams
- ✓ Network with over 200 leading financial planners
- ✓ Celebrate excellence at our gala awards dinner

"A must-attend for any serious professional financial planner"

– 2022 delegate

cisi.org/financialplanning23 **#financialplanning23**

Renew your CISI membership from 1 March 2023

Investing in your future today

Renew at
cisi.org/mycisi