The London Institute of Banking & Finance

Financial World

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ALL CHANGE?

Shock, awe and lending to SMEs
Andy Davis

Fintech: narrowing the gap
Richard Tomlinson

When equity brings release
Richard Northedge

ANALYSIS AND FEATURES

What's in the stars for Libra?
Tim Green

The spectre of stagflation
Jamie Dannhauser

The commodity of trust
Ouida Taaffe

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Lockdown opens up change

This issue of "Financial World" looks at the changes that the Covid-19 crisis has triggered and at the changes it is accelerating. Even before the country went into lockdown, branch banking was in decline. Now, fintech is firmly front and centre. And so is regulation. As countries grapple with profound economic challenges, and with the reshaping of whole industries, regulators are stepping up to deal urgently with topics that, just six months ago, looked like no more than part of a long to-do list.

What – apart from bailing out tanking economies – is keeping financial regulators busy? The future is front of mind. They want to ensure that fintech challengers can be viable competitors to incumbent firms so that the country can build back better, as Richard Tomlinson examines on p14. As banks migrate their data centres onto the cloud, regulators are working to firm up the line between where a bank's ends and the cloud begins, as Murray Cree and Sinclair Sinclair outline on p8.

The future is not just domestic for central banks. Many are considering whether to launch central bank digital currencies, and analysing what this might mean for their work as regulators and for their position in the world, says Dave Birch in his plea for a BritCoin on p55.

Central banks have been weighing up the pros and cons of a digital currency for a while. They have seen the use of cash slide and are interested in what a purely digital currency could mean for payments, for financial stability and for the role of banks. The Bank of Canada, for example, ran a developer challenge for a digital currency platform called MintChip in 2012. (It discontinued and sold MintChip in 2014.) Now digital fiat currencies look inevitable, but the plunge in the use of cash in many economies during lockdown is arguably just one driver behind their development. Facebook's plans for its own global digital currency, Libra, also galvanised regulators, who seem unlikely to give it a global green light, according to Tim Green's analysis on p28.

Facebook may not have realised just how stringent financial regulations are, and what a keen interest sovereign powers take in protecting fiat currencies, but the long drawn out talks between the UK and the EU over financial services post-Brexit shouldn't be a surprise to anyone. David Thomas, p31, provides an overview of EU thinking on its relationship with the City post-Brexit, and David Green, p10, argues that free trade in financial services is something the UK had come to take for granted. How quickly things can change in global trade is also discussed in our look at the upheavals in commodity trade finance and what they will mean for trade banks, on p33.

But trade and regulation are not just about rules, or even about politics. The internal culture of financial services firms is at least as important. Jakob de Haan and Wijnand Nuijts explain why, ten years ago, the Netherlands financial supervisor decided to look at the "softer", ethical, side of the way firms are run, and what the outcome of that examination was. Employee diversity is also often seen as a somewhat nebulous subject, but David Turner, p46, finds that research increasingly shows it is central to how well a firm can do.

No firm, and no country, is an island. Even large economies find that there are factors in the functioning of a financial system and of an economy that overpower domestic regulators. For example, as Jamie Dannhauser explains p40, the US Federal Reserve's decision to change a policy is a watershed moment for the global economy, not just for the US. And Paul Wallace, p36, highlights how machine learning can make markets malfunction precisely because it always follows the encoded rules.

Financial services has always had plenty of regulations, but it also has a long history of quirky creativity, as Dhruti Shah shows in her market bestiary, p45.

Creativity is something that is likely to be increasingly important as many routine tasks are automated in banking. The careers section, p48, looks at what the recent upheavals will mean for graduate and apprentice recruitment and 'Ask Nadim' gives advice on managing new staff remotely.

We also, of course, have the regular crossword at the end of the magazine. ■

Ouida Taaffe *is the editor of* Financial World

Help us to help others

Mike Cherry, chairman of the Federation of Small Businesses, welcomes government schemes to protect jobs and livelihoods but says much more needs to be done

Back in March 2020, when the UK entered Covid-19 lockdown, we at the Federation of Small Businesses called for meaningful support to help viable small firms to survive a period with extremely limited or, often, zero income. Thankfully, the Treasury put the protection of jobs and livelihoods to the fore and launched the Job Retention Scheme – promising to pay 80 per cent of employee wages in instances where staff couldn't work because of the new restrictions.

It was a bold and critical move. The word "unprecedented" is now hackneyed, but it's important to give credit where credit's due. The ability to furlough staff on the terms set out in the scheme has protected millions of livelihoods and businesses, laying the foundation for any economic bounceback.

At that time, we quickly identified an immediate need for progress. The government had yet to unveil plans for supporting our near 5m-strong self-employed community. Action soon followed, with the launch of the Self-Employed Income Support Scheme. It again covered 80 per cent of lost earnings, although was only available to those earning under £50,000. Grants were issued through a straightforward claims platform.

A slow recovery began to take place before the latest curbs were imposed when the pandemic flared up again. Some small firms were cautiously finding their feet, tentatively bringing back those who were furloughed, often on limited hours. And some sole traders were finding work once again. But the severe recession and the start of additional lockdowns mean that this remains an incredibly challenging environment.

As such, it was good to see the government outline new income support measures. The Job Support Scheme, brought in to succeed the Job Retention Scheme, and the next instalment of the Self-Employed Income Support Scheme are not as generous as the initiatives that preceded them. They are an evolution and, in the case of the former, an acknowledgement of lessons learned. At the heart of the Job Support Scheme is the flexibility that we always said would be integral to making income support schemes a success.

Working for the future

We need to look beyond the new restrictions and to start focusing on job creation. This crisis will permanently alter our economy over the long term. So we must focus on where future-proofed roles lie and how we can create them. We are a "gateway" in the government's Kickstart initiative – helping young people out of work to take their first steps into the workplace, or to find their way back into businesses after a spell away. Bringing the next generation of tech-native, fresh-thinking business people into small firms is a must.

This scheme promises to help us take great strides towards achieving that goal. Other initiatives – such as the Job Entry Targeted Support scheme and fresh incentives for small firms that take on apprentices – are also welcome and much needed. But there needs to be more development and improvement.

As this column goes to press, further restrictions are being introduced in parts of the UK. We could now be entering a new phase of support adaptation, one where the assessment of regional need – for access to full-time furlough once again, cash grants and tax deferrals – marks the starting point.

> *"Bringing the next generation of tech-native, fresh thinking business people into small firms is a must*

More widely, on the employer side, the cost of hiring remains prohibitive. Employer National Insurance contributions alone cost firms in the region of £4,000 a year for each member of staff on an average salary. Cut that outlay and you'll stimulate job creation. And on the self-employment side, far too many have been left out in the cold. Company directors, those earning more than £50,000 and those who are newly self-employed have received no meaningful income support. A rescue package for excluded groups across the board – including those still under government orders to remain closed – is urgently needed.

Another six months down the line and hopefully the UK will look a different place. With the landscape changing so rapidly, policy makers and businesses alike will have to keep adapting. Our economic future depends on it. ■



***Mike Cherry** is national chairman of the Federation of Small Businesses*

Which is the fairest firm of all?

Jakob de Haan and Wijnand Nuijts explain why the Netherlands financial supervisor decided to expand its oversight of financial services firms by holding up a mirror to ethics and they discuss the impact this has had on Dutch firms

After the Global Financial Crisis, public trust in banks took a pounding. Although that trust has recovered somewhat since then, worldwide the financial sector remains the least trusted according to the Edelman Trust Barometer. That is a problem for several reasons.

One, low trust in the sector may undermine financial stability. In the worst case, it may even lead to bank runs. Two, low trust may also damage the financial services industry and, with it, the wider economy. If the industry is not trusted, consumers will engage less. That means less business for financial services firms and, in turn, reduced availability of capital for productive purposes.

It is important to remember that trust in financial institutions depends on the behaviour of these institutions. Academic studies show that prudent behaviour, which is characterised by a long-term focus that takes into account the interests of all stakeholders – as opposed to short-term profit maximisation – has a positive effect on consumers' trust.

The role of financial supervisors

Although trust is ultimately generated by firms themselves, its importance suggests that financial supervisors should be mindful of fostering it. After all, the role of financial regulation is to safeguard the financial stability both of individual firms and of the sector as a whole. Today's undesirable behaviour at financial institutions is tomorrow's solvency and liquidity problem.

Even when the numbers suggest that a firm's continuity is not compromised, its corporate culture and behaviour may pose risks to that continuity. Research on board effectiveness shows, for instance, that supportive leadership styles and constructive debate between board members are important for good performance. Other research suggests that there is a relationship between organisational culture at a firm and the level of risk.

The policy of De Nederlandsche Bank

In April 2010, De Nederlandsche Bank (DNB), which is the financial supervisor in the Netherlands, was the first central bank to give the go-ahead for the development of the supervision of behaviour and culture at financial institutions. That ground-breaking policy was based on a paper first published in 2009: "The Seven Elements of an Ethical Culture". DNB emphasised the importance of balanced decision-making aimed at reconciling the conflicting interests of various stakeholders. It also highlighted the role of leadership and constructive challenge in that process.

Constructive challenge means a critical and investigative debate between board members in which diverse perspectives and situations, and their consequences and risks, are explored. But DNB's study also recognised that the quality of the challenge might be hampered by behaviour such as group conformity. The desire to reach consensus can restrict diverse opinions.

A new departure in bank supervision

In contrast to "traditional" supervision, behaviour and culture supervision is not about quantitative analysis. It uses qualitative methods taken from social and organisational psychology to determine behavioural patterns that are less tangible than financial indicators. Culture and behaviour can be compared to an iceberg. Looking at the tip of the iceberg gives you no idea of what is underneath. Most of what matters is out of sight.

DNB's approach distinguishes between three layers in a firm's culture: behaviour; group dynamics and behavioural patterns; and mindset. The deepest level of culture in this model is mindset. It refers to deep-rooted convictions and values. An individual's mindset determines how they view the world. It helps them decide who is reliable and who is not, and what has priority or importance.

Group dynamics refers to the underlying relationships between and among executives. Is the atmosphere conducive to board members calling each other to account for adverse behaviour? Is it one of collaboration, or of competition?

The third layer of culture, behaviour, is the most visible. DNB pays particular attention to behaviour regarding decision-making, leadership and communication. The essential question it asks as a supervisor is whether the behaviour seen in these three processes contributes to a firm's sound and ethical business operations and reduces its risk profile.

Ten years of holding up a mirror to behaviour

DNB was the first supervisory authority to target culture and behaviour as risk factors, and the first to incorporate this aspect in its supervision. So, what has it seen over the past decade?

It aims to identify behavioural patterns that may jeopardise the financial position, risk profile and integrity of financial institutions. In other words, supervisory authorities hold up a mirror to institutional behaviour and culture and draw executives' attention to the potential risks that arise from them.

> *Culture and behaviour can be compared to an iceberg. Most of what matters will be out of sight*

Since April 2011, DNB has conducted approximately 100 studies into behaviour and culture within banks, insurers, pension funds and trust offices, both in the Netherlands and abroad, using methods it has developed itself. These studies have yielded a wealth of findings on board effectiveness, change capacity, risk culture and ethical culture. Each of the examinations resulted in institution-specific findings, which are confidential, but we can share some general results.

It's the barrel, not the apples

DNB recently adopted a tool to try to identify behavioural patterns that could lead to misconduct before problems occur. It focuses on the root behavioural and cultural causes of misconduct at team level. Unethical behaviour is not considered a matter of individual "rotten apples". Instead, the DNB approach is based on the premise that individuals act in accordance with cultural values they receive from the environment in which they work. In other words, unethical behaviour largely depends on the barrel, not the apples.

What sort of culture can encourage misconduct? Results show that misconduct takes root more easily in the context of overambitious and/or unrealistic strategies, where objectives and decisions are focused on the short term and where priority is given to profit and/or growth at the expense of risk management and compliance. These ambitions may create an organisational climate in which individuals and teams are cautious to voice dissent, or even an alternative viewpoint.

That is especially the case where there is no psychological safety. Psychological safety exists when someone can speak out without fear of negative personal repercussions. As such, psychological safety is an "enabler" for denouncing unwanted behaviour. But firms need more than psychological safety to protect their integrity.

The way a company deals with errors can also be corrosive to good conduct. Many financial institutions react to mistakes by punishing those who have committed them or by failing to address them at all. Both approaches prevent organisational learning and may, therefore, set the scene for further bad behaviour.

Measuring integrity

The climate of integrity at firms is measured to find answers to the following questions:

1. What is the underlying mindset of the board and how does this influence the firm's objectives? Are these objectives realistic?
2. What is the degree of constructive challenge in a firm and to what extent is this encouraged (or not encouraged) by leadership, social norms and psychological safety?
3. How does a firm deal with errors? Does it learn from unintentional mistakes and is unacceptable behaviour addressed according to its severity and culpability?

To answer these questions, DNB uses a broad spectrum of quantitative and qualitative instruments, such as desk research, surveys, interviews, self-assessments and observations. Through data analysis and triangulation, it is possible to identify the underlying behavioural pathways. The approach is broad and aims to identify all possible root causes of misconduct, regardless of whether they arise from the organisational culture, structure or environmental factors.

Taking a hard look

To restore public confidence in financial institutions, financial services firms need to change some aspects of their businesses, including organisational behaviour and culture. But these changes require time and patience and a hard look in the mirror.

Change for the better starts with supervisors making executives aware of potential problems and making them willing to act. That triggers what may prove to be a prolonged trajectory of change at the organisation. DNB's experience is that most financial institutions that have been assessed follow up on the assessment on their own initiative. Providing a mirror apparently helps. ■



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Clouds on horizon for banks

Murray Cree and Callum Sinclair highlight how financial regulation of cloud outsourcing is being stepped up and discuss what this means for deciding where the cloud ends and a bank begins

When we were boys, we used to gaze up at the cloud-strewn west of Scotland sky and dream of being technology lawyers. OK, that's not strictly true, but work with us here.

What is true is that Scotland's weather made it hard to know where the clouds ended and the sky began. And examining blurred distinctions has stood us in good stead as technology lawyers. That is particularly the case now as we need to know where cloud technology ends and a bank begins.

Drawing that line boils down to whether you are an established financial services institution on a digital transformation journey, or a new challenger bank. The incumbents may have larger technology teams and budgets, but they are also saddled with substantial, legacy IT systems that are expensive to run. These systems are business critical and moving away from them requires substantial project planning, operational risk management and cash. Lloyds Banking Group, for example, earmarked £3bn for "a significant transformation" between 2018 and 2020.

Challenger banks such as Revolut, Monzo, Starling and Alba could start out with a blank IT canvas and have a much more flexible, and cheaper, "bank in the cloud". Cloud services are provided by third parties and support core banking, risk and compliance, finance and accounting, and payments. But while being a start-up in the cloud would seem to present an obvious advantage, it has significant regulatory implications.

Regulators shift up a gear

Over the past few years, there has been a raft of new legislation, guidance and updates on cloud outsourcing. The EU's second Markets in Financial Instruments Directive (MiFID 2) of 2014, for example, is now supplemented by the MiFID Organisational Regulation (MOR) of 2017. That nudged the Financial Conduct Authority's (FCA) rules on outsourcing into the "guidance" category. So, the outsourcing rules that currently apply for "common platform firms" in the UK – ie most banks, building societies and investment firms – are Articles 30 to 32 of the MOR.



But whether firms look at FCA or MOR rules, the key compliance themes for outsourcing remain the same:

1. no delegating of responsibility by senior management
2. proper supervision and adequate risk management
3. the ability to end the outsourcing arrangement without disrupting client service or service quality and
4. the cloud provider must cooperate with the financial firm to supervise the outsourced functions.

Banks have long used outsourcers, so reliance on the cloud may not seem like a departure. But the increasing number of firms migrating critical functions to the cloud (and the risks associated with large IT projects) have pushed some regulators to depart from their "technology neutral" stance.

> *The cloud offers technical flexibility but with that comes some operational risks and regulatory challenges*

In February 2019, the European Banking Authority issued new guidelines on outsourcing arrangements, integrating its 2017 guidelines. Key contractual requirements include:

1. access and audit rights to the premises of cloud service providers
2. supervision and auditing of sub-outsourcing by cloud providers
3. the creation and maintenance of robust contingency plans and exit strategies so that a cloud provider can be replaced without disruption and
4. avoiding "concentration risk" so that, for example, a cyber attack or IT failure at one cloud provider cannot disable the bank.

There's yet more regulation to come. In the insurance sector, the European Insurance and Occupational Pensions Authority has set out guidelines on cloud outsourcing, which are due to apply from 1 January, 2021.

Like the rules for banks, these aim to ensure appropriate monitoring and oversight of cloud outsourcing, including access and audit rights, security of data and systems, supervision of sub-outsourcing and exit strategies. While these guidelines will still apply in Europe, the FCA has said they will not apply in the UK given that they would have come into force after the Brexit transition period is due to end. Instead the FCA's existing cloud guidelines will continue to apply.

The effect of the end of the Brexit transition period on all of this is, as yet, unclear. Many financial services organisations have already split their operations, so at least some operations will need to continue to comply with the EU regime going forward.

The technical flexibility of the cloud has allowed for very rapid scaling, but with that come some major operational risks and regulatory challenges. Nevertheless, with the likes of Google having obtained payments and e-money licences in the EU, and applied for banking licences in other territories, there will be a lot more debate to come on what is "cloud" and what is "bank". ■



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Facing up to being single again

***David Green** looks at what it will mean for financial services when the UK leaves the EU's single market and why the consequences were barely discussed during Brexit*

Don't it always seem to go that you don't know what you've got 'til it's gone, says the Joni Mitchell song. This may well be the case with the UK's membership of the EU's single market in financial services. The single market took so long to build that it seems unremarkable. It is, in fact, the only moderately well-functioning free trade area for financial services in the world. It made cross-border financial services possible on a scale unknown anywhere else.

> *There was a sense in the City that politicians would not be keen to listen to arguments from well-paid bankers*

What makes the single market work? The cornerstones are: more or less uniform standards of regulation in many financial services sectors; mutual recognition of each jurisdiction's regulatory system; and recourse to a common legal system. That has eliminated many costs of doing business and enabled competition in financial services across the whole of Europe.

The practical consequences of the single market were never fully expected. Some markets migrated from national centres and coalesced in London. Some players, including from outside the EU, were able to establish a pan-European presence of considerable scale. It was also not fully expected that the introduction of the euro would accelerate this process, even though the UK was outside the eurozone. There were losers in this, and some have long memories, but the European Court of Justice meant the single market prevailed – because the court was obliged to enforce the level playing field that all members had agreed on.

The UK government's decision to leave the single market risks blowing up this structure. Dismantling the single market in financial services was not a foregone conclusion after the Brexit vote and had never been debated in any detail. Given that it brought so many benefits to the City, why were the consequences of ditching it barely discussed?

There are several reasons. Not everyone in the UK benefited from the cross-border trade opportunities created by the single market, even though they suffered the regulation needed to create a pan-European, level playing field. When, as they saw it, there was no value from EU membership in the domestic market they were actively in favour of leaving. Larger domestic companies were also reluctant to appear to go against the perceived wishes of perhaps half their customers. Foreign companies were hesitant to seem to become involved in UK domestic politics. And, in any case, they had the option, albeit at some cost, of rearranging their affairs.

In the City, there was a sense that politicians would not be keen to listen to arguments from well-paid bankers who were still held responsible for the financial crisis and



whose pleading, for some at least, had more than a whiff of entitlement. The City consensus, such as it was, was to point out that there would be costs to reimposing trade barriers – both for the UK and for the City's European customers. That argument, so they hoped, would save at least some parts of the single market arrangements.

These attempts fell foul of arguments on both the UK and the EU sides. In the UK, the stumbling blocks were the philosophical and supervisory objections around the idea of sovereignty. In the EU, there was a strong sense that the voluntary departure of the UK provided an unanticipated windfall opportunity. Suddenly, eurozone states would be able to reshore business they had lost.

When the single market was set up, few had foreseen the extent to which a winner would take all in financial services. Markets had been local. London's dominance was possible partly because the development of technology allowed trading to be decoupled from those local markets.

> *After Brexit, some significant financial activities currently offered out of London will become prohibited in the EU*

But the eurozone did not just see opportunity in the end of the single market in financial services. There was also the promise of relief from the long-standing discomfort of having key financial infrastructure for a currency outside the jurisdiction of issuance. And, if the protection of both national companies and consumers in the EU was going to rely on supervisors that were no longer bound by a common supervisory framework, and could even diverge from it, having vital infrastructure in London no longer seemed tenable.

For these reasons, the end of the transition period will mean barriers to business and the economic consequences that come with them. At the time of writing, which barriers will go up and by how much is not known. There is legal scope for some areas of financial regulation to be found "equivalent" and for the corresponding services to continue to be allowed cross-border. But even this is in some doubt.

Rhetoric about deregulation on the UK side has provoked a reaction on the EU side. This is despite the fact that the supposed deregulation will either not happen because it is not supported politically, or will only apply to domestic business. There is little or no pressure in the UK for deregulation of banking or securities business relevant to the single market.

What is certain is that, after Brexit, a significant range of financial activities currently offered out of London will become prohibited in the EU. Those activities will, therefore, have to take place through other channels, or not at all. New entities will need to be – and are being – set up. That can entail financial firms setting up in new locations to supply services or companies establishing offices in another jurisdiction to access them.

What that will mean for the cost and availability of these services is impossible to say at this stage. Much will depend on the ability, and willingness, of financial services firms to offer services in a jurisdiction that will no longer be accessible cross- border. And much will depend on the capacity of customers to switch the location in which they use those services.

What is often overlooked is that many of the financial services Brexit will disrupt are in wholesale markets. Those markets have no connection with the ultimate, non-financial user of the service. So, much of what happens next will depend on the extent to which wholesale markets develop on each side of the new barrier. This will inevitably evolve over time as players adapt their business models to the new reality.

Certainly, the Capital Markets Union project will be made more complex by the erection of new barriers to capital flows. It is to be hoped that new equilibria will be found quickly, but so much will change that some market disruption cannot be ruled out. That will particularly be the case if some smaller players, whether financial or non-financial, prove to be inadequately prepared.

This is perhaps not the kind of world – more expensive and more inefficient – that Brexiteers had in mind. There won't be lorries full of money queueing at the border, so the disruption may not hit the headlines. It won't be any less real for that.

Free trade in financial services was carefully built up step-by-step over a quarter of a century. It has taken the City a long time finally to appreciate what is being taken away. ■



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The London Institute of Banking & Finance

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Hard times and software

In this special series of articles, **Financial World** *looks at the changes the pandemic has triggered in the financial services sector – from bancassurance to SME lending*

On 30 April, 1665, the London diarist Samuel Pepys wrote: "Great fears of the Sickenesse here in the City, it being said that two or three houses are already shut up. God preserve us all." Thanks to antibiotics and modern sanitation, outbreaks of the Black Death such as those in 1665 are now mostly confined to history books. But the microbial world always has plenty of new, and potentially very unpleasant, surprises. And just as in the seventeenth century, plague means angst and upheaval for the City.

The cover stories in this issue of *Financial World* look at the changes that Covid-19 has either triggered, or accelerated, in financial services and what they could mean for segments from bancassurance to SME lending.

The central trend is the move online. Banks have been digitalising their businesses for decades. They were among the first to install their own mainframe computers back in the 1960s. Paradoxically, the amount they invested in in-house data processing may have made them laggards in the most recent drive for software-driven services. They had large installed IT bases that were expensive to run, needed constant upgrades and were perilous to swap out.

The shift to agile core systems hosted on the cloud had begun before Covid-19 hit, but the mass consumer migration to online services and increasing fintech competition have concentrated minds, as the article on p22 outlines. So central is software now to banking that the European Banking Authority announced in mid-October 2020 that it's going to allow banks to start amortising the value of software assets.

A software-led business model clearly meets customer preference, but that is not the only driver. A vibrant fintech industry has strong regulatory support. As Richard Tomlinson explains, p14, the regulator is minded to ensure that fintechs help financial services to "build back better" after the pandemic crisis. That includes boosting financial inclusion, and getting funding down into all of the cracks of the financial system.

The UK economy is likely to need all the help it can get. Andrew Bailey, governor of the Bank of England, told the House of Lords' Economic Affairs Committee on 13 October that "the recovery will take time" because of the second wave of the pandemic and because people are cautious about spending and socialising. As Andy Davis outlines, p17, emergency bail-outs of SMEs, vital in preventing mass bankruptcies and large-scale unemployment, are likely to lead to many non-performing loans and limited lending capacity at banks. A bad case of financial indigestion could, in turn, be problematic for spending, investment and for the much-needed increase in overall productivity. It could also mean a widening of the regional divide. And that is before Brexit adds to the bumps in the road.

> *A far greater reliance on online financial services is likely to be one of the lasting legacies of the pandemic*

One bright spot on the horizon when it comes to boosting spending may be the equity release market. A lot of money is tied up in the UK's housing stock, much of it held by older people. Richard Northedge, p20, explains why, even if house prices fall, there will still be plenty of scope for homeowners to tap a rapidly developing market.

Equity release has been around for some time but it is not the only old-time financial services product that might be revitalised by the pandemic. Bancassurance – banks offering insurance – was a fashionable strategy that never really delivered on its promise. But now, the insurance industry's rapid switch to digital services promises to change that calculation, as Tony Gandy explains on p25.

The pandemic is flattening much of the UK economy. What will bounce back, or grow out of what remains, is still unclear, but a far greater reliance on online financial services seems set to be one of the lasting legacies.

That is already reshaping how banks function. For example, TSB is closing an additional 164 branches, taking its network down to 290. Seven years ago, it had 631. There will be inevitable job cuts, 969 in total, although 120 roles are being created. And TSB is not alone in this accelerated move online. Bank branches increasingly look like a drag on profits. In France, for example, HSBC has reportedly been offered just €1 for its 270-branch retail business by the investment firm Cerberus and was asked to invest at least €500m to make the deal palatable.

If you would like to follow the latest developments in digital finance, or see what courses The London Institute of Banking & Finance is launching to help people make the transition to the new normal, the Centre for Digital Banking and Finance is there to help. ■

Ouida Taaffe *is the editor of* Financial World

Narrowing the gap

Richard Tomlinson *reports on how the pandemic could trigger regulatory policy changes that will help fintechs to enter the financial services mainstream*

There are currently two apparently conflicting views on the regulation of fintechs. In the first, fintech banks are still hindered by a regulatory regime that unfairly favours the incumbents. In the second, Covid-19 has triggered a decisive policy shift that will enable fintechs to enter the financial services mainstream. But there may be truth in both, suggesting a rather more tangled plot.

This complexity was highlighted in August, when it emerged that the Bank of England had raised capital requirements at digital bank Monzo from 9 per cent to 13.65 per cent of risk-weighted assets, plus a fixed amount of £21m.

> *Regulators should remove barriers to allow successful start-ups to grow and compete with the incumbents*

That came just as Monzo embarked on a fundraising round. Superficially, the story lent weight to the charge that fintechs are constrained by unduly stringent capital requirements compared with the incumbents. Yet the case made by the fintechs is more nuanced, focusing on how regulators and policymakers can do a better job of monitoring and supporting digital lenders once they progress beyond the start-up phase.

"What we would like to see is a journey that moves in stages in a more manageable, sustainable way," says Iana Vidal, head of policy and government affairs at Innovate Finance, the UK fintech sector's industry association.

At the heart of this case is what happens when early-stage fintechs leave the security of the Financial Conduct Authority's (FCA) regulatory "sandbox" for start-up firms. The FCA created the sandbox in 2014 as a safe space for start-ups to test whether their business model was robust enough to survive on a fully regulated playing field.

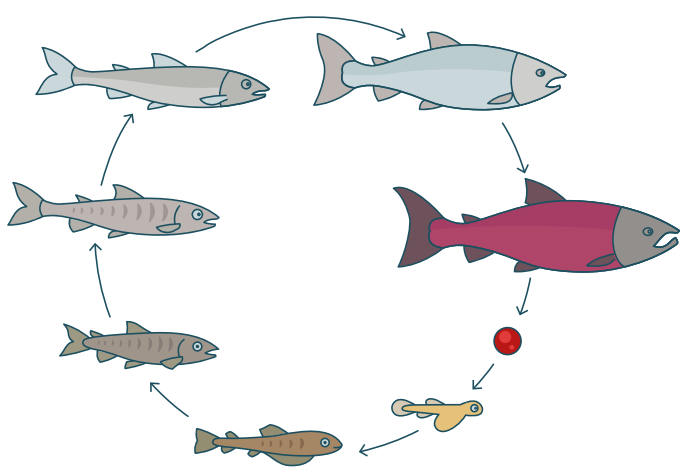
"The UK has been a fantastic environment for fintech start-ups to get established," says Nick Lee, head of regulatory affairs at OakNorth Bank, a digital-only UK bank that specialises in lending to smaller mid-market companies. "The policy focus now for regulators should be on removing barriers to scaling to enable successful start-ups to grow and compete successfully with the incumbents."

OakNorth illustrates Lee's point that there is a cohort of mid-stage UK fintech lenders, including Monzo and its rival Starling, that occupy an intermediate space between the digital start-ups and the big high-street banks. Launched in 2015, OakNorth nearly doubled its pre-tax profit in 2019 to £65.9m while attracting deposits from 144,000 savers, up from 28,000 in 2018. It's not a banking minnow, yet nor is OakNorth (or Monzo or Starling) anywhere near the scale of an incumbent such as Lloyds Banking Group, which registered pre-tax profit of £4.39bn in 2019.

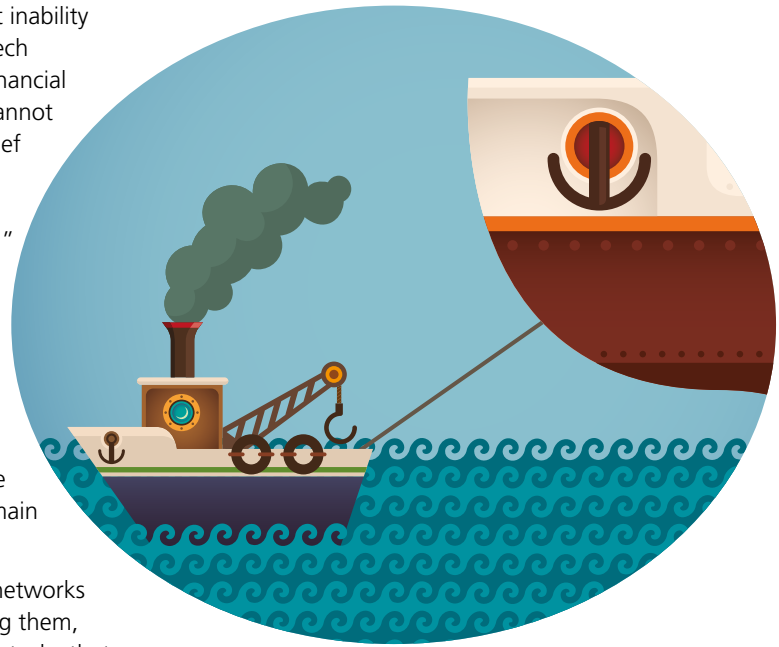
Lee was previously responsible for the authorisation and supervision of new banks at the Prudential Regulation Authority before joining OakNorth in 2017. He suggests that precisely because of their smaller scale, established fintech lenders such as OakNorth "don't pose the same risk to the banking system as one of the incumbents and therefore we feel some of the regulations should be more risk-based and proportionate".

The policy shift that Covid-19 built

It's here that the second storyline surfaces. For, while there is no evidence that the FCA is minded to set up an intermediary sandbox for established digital lenders, there are increasing signs that regulators and the Treasury see fintech challenger banks as integral to building UK financial services "back better" in the wake of the pandemic.



To some extent, this is a story about the persistent inability of the incumbents to use the full potential of fintech innovation to improve customer service. "Large financial services firms are like huge battleships and they cannot pivot quickly," says Holly Mackay, founder and chief executive of Boring Money, a personal investment advisory company. "They need nimble fintechs to show them what good looks like at the front end."



In addition, the perception of fintech lenders as serving a social purpose received a boost at the start of the Covid-19 crisis because of the failure of the incumbents to fulfil an urgent mandate. In March, when the government launched its Coronavirus Business Interruption Loan Scheme (Cbils) for small and medium-sized companies, the cash was at first distributed entirely through the main high-street banks.

It rapidly became apparent that the incumbents' networks could not reach many of the smallest firms, among them, ironically, traditional high-street businesses. The fintechs that covered this market began lobbying to fill the gap. In April, OakNorth and Starling were added to the list of authorised Cbils lenders, to be joined over the summer by other digital challengers such as ThinCats, based in the Isle of Man, and the UK-German bank Iwoca. "The fintechs demonstrated they had a really key role to play, in using their technology and credit analytics to get the money out of the door," says Vidal.

A new "digital" sandbox

Despite the Treasury's false start with the Cbils programme, Covid-19 has in fact added urgency to efforts by regulators and policymakers to improve the chances that the best fintech start-up lenders will evolve into robustly competitive banks, in a market where the pandemic is accelerating the permanent closure of physical branches.

In July, the FCA announced a partnership with the City of London Corporation to develop a new "digital sandbox" that would enable participants to test their latest technology services in a safe regulatory environment before full market launch. This initiative – in effect, a focused, high-tech version of the existing sandbox – aims to establish "a platform to tackle the challenges that will face the financial services sector in the recovery from Covid-19," said Christopher Woolard, the FCA's interim chief executive at that time.

The same month, the Treasury launched an independent review of the UK's fintech sector, postponed from March because of the lockdown. Headed by Ron Kalifa, the former chief executive of Worldpay, a payments processing company, the review will explore how the state can help the sector maintain its "global reputation".

In September, Tech Nation, the government-backed networking platform for digital entrepreneurs and investors, launched a "Fintech Pledge" to prompt wider collaboration between incumbent banks and the sector. Barclays, HSBC, Lloyds Banking Group, NatWest Group and Santander were among the early signatories.

> *"The Fintech Pledge sets out what fintechs can expect from banks and how to create productive collaborations*

"Fintechs regularly cite partnerships with financial institutions as both one of their greatest opportunities but also the biggest challenge," says Victoria Roberts, director of Tech Nation's Fintech Delivery Panel. "The Fintech Pledge should bring a welcome clarity, setting out clear commitments about what fintechs can expect from banks and how best to create productive collaborations."

It's easy to dismiss such initiatives as window dressing by the incumbents. Regardless of Covid-19 and Brexit, fintech lenders face the same routes to failure or success they have always done. They can fail principally because they are too small to succeed; they can be acquired by a larger fintech or

one of the incumbents; or they can continue to operate as specialised lenders targeting usually smaller businesses and personal customers whom the incumbents ignore or cannot reach.

As for Brexit, fintech lenders confront the same uncertainties about the post-EU future as the rest of the UK's financial services sector, with similar divisions of opinion. A good illustration is whether liberation from the EU's Second Payment Services Directive (PSD2) represents an opportunity for fintechs or a headache. According to Vidal, some digital lenders sense a potential benefit if they can propose a credible, innovative technology-based alternative to the current rigid PSD2 rule that online account holders must be "re-authenticated" every 90 days. But other fintechs see the 90-day rule as providing necessary security, with no common sector-wide position.

Amid the uncertainty, what is clear is that Covid-19 and Brexit are speeding up the erosion of regulatory distinctions between fintech lenders and incumbent banks, all of which have fast-growing fintech divisions and businesses. The fintechs might not be too big to fail (and many will), but they have shown their social importance in helping get money to where it is needed. They are no longer niche.

"Over the last five years, brand awareness in financial services has overtaken the idea that this is my bank or my insurer," observes Vidal. "At some point, we will stop talking about fintech and the rest of financial services because they are intertwined and connected." And then, we may know as well whether any of the current crop of fintech challenger banks have what it takes to become incumbents themselves. ■



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Shock, awe and SME lending

Andy Davis examines how government-guaranteed bank lending to small firms could lead to market distortions and a huge bad debt problem

The UK government's approach to protecting small businesses from the impact of Covid-19 has been unashamed shock and awe: it has thrown unprecedented amounts of money at the problem and progressively reduced the number of strings attached.

By 20 September, the furlough scheme had consumed £39.3bn, much of it paid to SMEs' employees. Two support schemes for the self-employed accounted for another £13.4bn. Companies themselves also got direct support. The Coronavirus Business Interruption Loan Scheme (Cbils) provided £15.5bn, with an 80 per cent government guarantee to smaller companies. The Bounce Back Loan Scheme, for the very smallest firms, which carries a 100 per cent government guarantee, lent over £38bn to 1.26m UK businesses. It did so at a fixed 2.5 per cent interest rate – far below commercial rates. Both schemes charge no interest or fees for the first year and the Bounce Back loans require no repayment of capital during that period either. Finally, some £720m in convertible loans had been advanced from the Future Fund to early-stage, pre-profit and even pre-revenue companies.

> *"The crunch will come next spring when repayments on loans are due to begin and VAT bills also fall due*

That's a lot of financial firepower, but the government is also riding shotgun in other ways. Business rates relief in England worth £10.7bn has been granted, with another £2bn for the devolved administrations. Around £27.5bn of VAT payments due from almost 500,000 businesses has been deferred to the end of the tax year, and £11bn has been paid in grants to small businesses based on the rateable value of their premises.

As lockdown measures to control the first wave of the pandemic bit, the government's priority was to offer temporary support for companies' cash flow. But the realisation has now dawned that any return to normality remains months away and, with Covid-19 infections rising quickly again, restrictions on activity will be in place for much longer than hoped. The Treasury responded on 24 September by extending its loan schemes, most of which were due to close at the end of September. Now, they will remain open until 30 November and new support schemes are reported to be on the agenda for 2021. A temporary ban on evictions from commercial premises was also extended for three months until 31 December.

Not only will loans be available for longer, but conditions were also loosened significantly. The maximum term for both Bounce Back loans and Cbils was pushed from six years to 10. For the smallest companies, the interest-free period was extended into a second year. Over the course of the loans, those micro borrowers can also have three periods when they make interest-only payments for up to six months and one option to suspend repayments altogether for six months.

These attempts to defer the looming prospect of mass insolvencies are essential, but they would not happen without a government guarantee. The government acknowledges widely voiced fears that 50 per cent or more of emergency lending will not be repaid. Its latest projections suggest that the state's losses on emergency loan schemes, especially the Bounce Back loans, which require no credit checks, could range from £12.9bn to £23bn, although that forecast covers only loans made up to August. In July, the Office for Budget Responsibility forecast that up to 40 per cent of emergency loans could go bad.



Bad loans and few good options

In effect, the government has decided that the risk of creating a legion of zombie companies, loaded with debt they are unlikely to repay, is the lesser evil. As TheCityUK's recent report on recapitalising Britain makes clear, the UK will face a major bad debt problem among its small businesses, with the crunch time potentially arriving next spring, when repayments on their government-backed loans are due to begin and deferred VAT payments also fall due.

TheCityUK suggests that by next March SMEs will be carrying around £100bn of unsustainable debt, of which about a third will be accounted for by the emergency schemes, especially Bounce Back loans. In a blow for the government's regional "levelling up" aspirations, the report suggests 75 per cent of this unsustainable debt burden falls outside London.

Among its recommendations is the Business Repayment Plan, which would convert Bounce Back loans and smaller business interruption loans into some form of tax obligation, to be recovered via payments to HMRC as businesses' activity levels pick up. This would be akin to the recent trend for linking lease payments on retail properties to the occupier's turnover. It would also make the huge stock of government-backed lending to small businesses look increasingly like the student loans scheme – liabilities that will be repaid, if at all, only when the borrowers can afford it. Many will turn out to be grants in all but name.

The role of non-bank finance

Given that many small firms will struggle to repay what they had to borrow to get through lockdown, how will they fund recovery and growth once the pandemic is over? Even if they could find a willing lender, additional debt might cripple them.

> *It is looking like the student loans scheme – liabilities will be repaid, if at all, only when the borrowers can afford it*

Alex Brazier, the Bank of England's executive director for financial stability and a member of the Financial Policy Committee, argues that injections of growth equity from long-term investors such as pension funds should play a much bigger role in helping to recapitalise the UK's over-indebted SMEs. UK-listed companies raised the largest sum in new equity in a decade during the first half of 2020, but



only a small subset of private UK companies is in a position to follow suit. And that subset largely consists of those that already have external investors, notably private equity firms.

For most small private firms, and especially companies borrowing through Bounce Back loans and Cbils, there is no prospect of external equity investment. That is because there are no potential exit routes for investors. But it is also because most small owners don't want external investors.

"Businesses told us that they remain highly sceptical of looking at traditional equity solutions," Omar Ali, UK Financial Services Lead at EY and a member of the steering group for TheCityUK's report on recapitalising UK business, told an online discussion organised by the Centre for the Study of Financial Innovation in August. "It's not something that they've used before; it's not something that they are particularly au fait with."

For most, therefore, debt will remain the only option – and government-backed schemes the only realistic source. There are non-bank lenders that serve the SME market, of course, but the issue for them is that the bank-dominated government schemes have effectively swamped their market. Their lending outside these schemes has fallen almost to zero.

Stuart Law, founder of Assetz Capital, a leading non-bank lender to small housebuilders that is accredited for Cbils, says: "Cbils will be above 95 per cent of our lending until

the scheme ends." Funding Circle, the largest non-bank lender to UK small businesses, has paused all non-Cbils lending and had approved about £1.2bn of loans under the scheme by 20 September. Its lending volumes between June and August were up more than 30 per cent year-on-year.

For Iwoca, a large online direct lender that targets the same microbusinesses that Bounce Bank loans are aimed at, the launch of this government scheme, offered exclusively through the banks, has effectively closed its core market. Iwoca's cost of capital from institutional investors means it cannot match the 2.5 per cent borrowing rate on Bounce Back loans – or the 12-month payment holiday. But, in addition, many Iwoca borrowers have used Bounce Back loans to refinance their Iwoca balances with cheaper money, shrinking the company's existing book, says founder Christoph Rieche.

These emergency schemes have also had a dramatic effect on the banks' stock of SME lending. Law points to Bank of England figures that show the SME loan stock of banks standing at £167.5bn at the end of February, having been steady for around three years. By the end of August, it had reached £206.2bn.

> *"The big question is what level of risk the government wants to continue to take in small business lending*

"That brings their loan stock back to where it was before the financial crisis of 2008-09," he says. "That's way above their comfort levels, in my view. I can see there being very limited appetite for normal lending by the banks if it's not inside Cbils." Once Bounce Bank loans end, banks' appetite to lend small sums to microbusinesses will have been "used up for some years to come", Law believes.

Borrowing beyond the hilt

If small businesses have already borrowed up to the hilt, how is that lending market likely to develop from here? Both Law and Rieche expect the Treasury to announce a new lending scheme from January that will closely resemble Cbils. In effect, this would replace the long-established Enterprise Finance Guarantee scheme with a successor that is more generous and less complex to administer.

"I think they will take the learnings from the Cbils and use them to improve the Enterprise Finance Guarantee scheme," says Rieche. "But the big question is what level of risk the government wants to continue to take in small business lending. Inevitably, the more that is guaranteed by the government, the more distortion you will have in the market."

Assuming that the successor to Cbils is open to non-bank lenders as well as banks – and the Enterprise Finance Guarantee scheme is not – this could provide a big fillip to the non-banks. But it would mean that for the foreseeable future a large percentage of lending to smaller companies in the UK is likely to carry a government guarantee of up to 80 per cent. That amounts to a significant market distortion that will fall hard on any lender unable to use the scheme.

Bounce Back lending – what Rieche calls "a better version of a grant scheme" – is unlikely to be extended beyond 30 November, he says. He believes that after that point banks will have neither the risk appetite nor the systems to provide additional funding to that many microbusinesses. The challenge then will be to help the microbusinesses that flocked to banks for Bounce Bank loans to find their way to non-bank sources of finance when they next need funding. That could require reforms to the current bank referral system, so that a company doesn't have to be formally refused finance by a bank before it is referred.

There are some reasons to be optimistic. In its most recent results, Funding Circle chief executive Samir Desai said: "We believe that Covid-19 has led to an acceleration in the adoption of online small business lending." If the transition to online borrowing is sustained, it is likely to benefit the web-based business models of non-bank fintech lenders, which tend to be faster and more user-friendly than banks' online offerings.

Law sees Assetz Capital's core market – SME housebuilders – as a bright spot, with demand for new homes and development loans likely to remain strong. But prospects for the wider market look mixed at best. Having completed several years' worth of new lending in a few months, many banks will be experiencing the early signs of chronic indigestion. At the same time, many returning borrowers will look stretched on most conventional measures of affordability. If the banks' SME loan balances are to shrink at any speed, it is more likely to be a result of write-offs than repayments. ■



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When equity brings release

The equity release market took a hit at the start of the pandemic but, as sales begin to climb again, ***Richard Northedge*** *says it could play a part in the UK economic recovery*

It shouldn't be a surprise that the equity release market collapsed this summer: the target customers were self-isolating in the homes they would be mortgaging, many shielding against coronavirus, too uncertain about their immediate future to concern themselves with long-term finances. After two quarters when sales of equity release plans exceeded £1bn, the April-June total was down to a four-year low of less than £700m, according to the Bank of England.

Yet the pandemic may prove a boost to equity release. When older people are faced with minimal interest rates on savings, cancelled share dividends, declining annuity rates, falling wages or disappearing jobs, turning the illiquid asset of their home into income or capital may be an answer. And even if parents' own finances aren't threatened, they can use equity release to help struggling adult offspring.

> *The recent trend has been to use the money released to stabilise finances rather than enhance lifestyles*

Lockdown and home-working may also mean more potential customers are educated by daytime television commercials on the mysteries of a product also called a lifetime mortgage. Nowadays, there are few "home reversion" plans that give the finance company a share of the property. Most equity release involves a loan that has no interest or capital repayments until the owner moves or dies. Interest rolls up. The loan is secured on the property but the borrower retains title and all future increases in value, including the benefit of extensions and improvements – minus the eventual repayment.

So, while conventional borrowers worry about payments, default or repossession – and may be seeking mortgage holidays – equity release ignores job prospects, income or credit scores. In fact, it can strengthen household finances. Customers take a lump sum or draw down funds. Drawdown is most popular, although the first instalment often is the bulk of the available funds and pure lump sums have risen from 38 per cent to 45 per cent of plans since 2016.

Repaying debt – including existing mortgages – is the most common use of the money released. The recent trend has been to stabilise finances rather than enhance lifestyles. Funds to finance holidays halved to 4 per cent this summer, according to Key Equity Release, a major broker of plans, with home improvements also down, but debt repayments, including credit cards and loans, rose to 44 per cent of funds released.

Most customers under 65 repay debt while older borrowers take cash to help their families. Age – or, more precisely, life expectancy – is the key determinant in this market. Loan limits rise with age. An 85-year-old could borrow half the house value, a 55-year-old (the minimum age) just 20 per cent. In practice, the actual averages are 38 per cent and 24 per cent and the older the borrower, the more likely they are to take drawdown rather than a lump sum.

The average age of new borrowers has fallen to 70 even though retirement ages and life expectancy are rising. Almost half the borrowers are in their 70s, with 41 per cent in their 60s: the over-80s and under-60s each account for just 8 per cent. Couples comprise three-fifths of customers, single women a quarter, single males one in seven, with the men more likely to be repaying debt, including car loans.

London and the South East have led demand, accounting for almost half the market in the first half of 2020 – higher property values release more equity but also make the process more worthwhile. But the regions are catching up and, despite Covid-19, the North East and South West saw more deals than last year in the April-June quarter. The value of deals in Yorkshire and the Humber also rose.

Nationally, the average loan is £74,000 on a £321,000 property and while loan-to-value ratios in all regions average roughly 23 per cent – a ratio that is steadily rising – the £46,000 North East release compares with £143,000 in the capital. London borrowers are the oldest at 72; Northern Ireland's new customers average 67 years old.

As the equity release market expanded over the past decade, its interest rates fell even faster than other mortgage rates. Yet this year they apparently ignored the Bank of England cuts, even rising slightly to average 3.18 per cent in the second quarter – although rates just above 2.5 per cent are available.

As the main lenders are life companies, not banks, pricing may reflect gilt yields rather than bank rate. But rolling up

at 3 per cent means 65-year-olds will be 90 before their debt doubles. At 6 per cent, they will be just 77 – although, hopefully, property prices will have risen too and lenders guarantee that debt will never exceed house value. This year, one equity release deal in eight was remortgaging to a lower rate.

Seemingly high interest rates exacerbate an industry image that remains tarnished by past practices. While big name insurance companies are now driving the market, customers are obliged to consult independent advisers who may not always ask as many questions as they should. In June 2020, a Financial Conduct Authority (FCA) report said advisers didn't challenge customers' demands for equity release, the advice on equity release didn't always fully reflect personal circumstances, and firms couldn't provide evidence that advice was suitable. By FCA standards, that's mild criticism but the trade body, the Equity Release Council, quickly doubled its adviser checklist to 24 points.

Equity release can provide financial breathing space, but it's not the solution to all problems. It can be an expensive way to repay short-term borrowing and early repayment can incur five-figure fees. Removing younger partners from title deeds

> *As the market grows, lending terms may loosen to include freehold flats or high-rise council homes*

to meet the over-55 borrowing qualification is especially worrying. But demographics should underwrite the equity release market's future growth. An estimated 4.7m over-65s own £1.12tn of mortgage-free property. And while the South East and London dominate by value, there are four times as many potential customers elsewhere in the UK and the regions are increasingly unlocking their property wealth.

The total over-65 population is forecast to double to 20m over 50 years, with an increasing proportion of property owners but more people entering retirement with debts. While Prudential dropped out of the equity release market just before it took off, Legal & General moved in and, with Aviva and others, is promoting the concept of turning bricks and mortar into cash. As the market grows and competition widens, lending terms may loosen – to include freehold flats, for instance.

May 2020 was the nadir for equity release, with sales down 40 per cent, but they started recovering in June. For the medium term, the post-pandemic economic outlook



suggests that more people will be looking to monetise their wealth. Raiding pension funds remains popular (although the minimum age will rise to 57 in 2028) but there are tax advantages in releasing equity instead. In particular, the mortgage lowers the estate value for inheritance tax and the untouched pension pots can be passed on tax-free.

A fifth of equity release proceeds are already given away and that could rise if more parents use their own wealth to help children whose jobs or housing prospects are hit by recession. And if the post-lockdown bounce in property prices turns into the widely predicted slump, equity release will not be held back by difficulties in selling.

The pandemic did older people no favours, but equity release may allow that cohort to help reflate the economy. More than £4bn a year was being transferred from institutions to households before the crisis and, after repaying debts, that goes into home improvements, new cars or boosting everyday spending, with much trickling down to younger generations. As equity release spreads through the regions and to a younger market, the conversion of housing wealth into cash has a part to play in the economic recovery. ■



Richard Northedge *is a former banking journalist of the year and was deputy City editor of* The Daily Telegraph

Banks beware. BigTech's coming

Fintech start-ups struggle to compete with incumbent banks but the entrance of BigTech companies into consumer banking could spell radical change, ***Ouida Taaffe*** *reports*

Back in 2000, tech stocks imploded. Many investments that, only a few months earlier, looked viable sank fast. The list of expensive failures is long but there are some stand-outs. The fashion site Boo.com, for example, made headlines as dotcom royalty. It had backing from Bernard Arnault, chair of LVMH; from the Benetton family; from Goldman Sachs; and from JPMorgan, among others. It folded after 18 months, having burned through a reported US$135m.

The Covid-19 crisis has led to a similar shake-out in fintechs. It is not as dramatic as the dotcom crash, but some big names have been tarnished – among them high-profile neobanks. Monzo, for example, announced in its 2020 annual report in August that the pandemic crisis had cast "significant doubt" over its ability to continue as a going concern.

Although Monzo has a big profile, it is a small company. Its annual report said that it had 3.9m customers, revenues of £47.5m and deposits of £1.39bn. To compare, the UK's largest incumbent retail bank – Lloyds – reported 17m active digital account customers in the first half of 2020 and overall retail net interest income of £4.2bn.

Because competing against the deep pockets and large installed base of incumbents such as Lloyds is an uphill battle for neobanks, the UK financial regulator has done its best to encourage competition from fintechs. (Richard Tomlinson discusses this on p14.) But the incumbents are not standing still and they are willing to invest – perhaps more so than their challengers – because the stakes are high.

"For an incumbent bank, there is no one answer on tech return on investment," says Rakefet Russak-Aminoach, the former chief executive of Bank Leumi, an Israeli incumbent, and now chief executive of Team8, a venture capital firm. "Usually, if you don't make those investments, your chance of surviving is limited. It is not a question of counting when you will get the investment back."

Who's afraid of BigTech?

If fintechs are struggling to compete with incumbents and a shake-out in that segment is under way, what poses the more immediate threat to big banks?

BigTech has already disrupted some industries that looked unassailable, including music and publishing. The day when it enters front-end, retail financial services has long been feared in banking. And that day is getting closer. Google is working with eight US banks to launch mobile-first bank accounts within the Google Pay app in 2021. The new accounts will reportedly offer "financial insights" and "budgeting tools".

In addition, earlier in 2020, the head of Google Finance in the UK placed an ad on his LinkedIn feed looking for someone with "deep industry experience to develop partnerships with the biggest banks in Europe, the Middle East and Africa (EMEA)".

What does BigTech want?

Google has both the technological know-how and the balance sheet to compete vigorously in many industries. But does it want to compete with banks? And is it the disruptive threat to retail financial services that people fear?

> *Big Tech will embed fintech into their services as much as possible, as long as they don't have to deal with regulation*

"I think incumbent banks are facing huge disruptions, but I don't think those will come mainly from BigTech," says Russak-Aminoach. "The reason for that is that financial services has a lot of very local components, not just currencies and financial governance, but also rules on regulation and compliance that vary from one geography to another. At the end of the day, the regulator in each and every region wants to own the destiny of its financial system."

But she doesn't discount BigTech as a coming force in financial services. "I think BigTech will embed fintech into their services as much as possible, as long as they don't have to deal with financial regulation," she says. "Financial services is one of the world's biggest sectors, so there is enormous potential for revenues and for increasing customer stickiness."

What retail banks face

BigTech, then, has good reason to be a visible presence

in financial services – as long as it can avoid the snares of financial regulation. If nothing else, regulation could turn out to be a major headache much closer to home if the recent US Congress report on Investigation of Competition in the Digital Marketplace starts to develop teeth. The report found a "clear and compelling need to strengthen antitrust enforcement and consider a range of forceful options".

But regulation is not just a burden. The challenges that come with being a regulated financial services provider, particularly working across multiple jurisdictions, provide incumbent banks with a moat. Even when the regulator is on their side, newcomers struggle to compete. Small, new banks, for example, face higher capital risk weighting than incumbents do. The high level of regulation also means that consumers tend to trust banks. However, even if that regulatory, and reputational, moat is formidable, the castle behind it may not be.

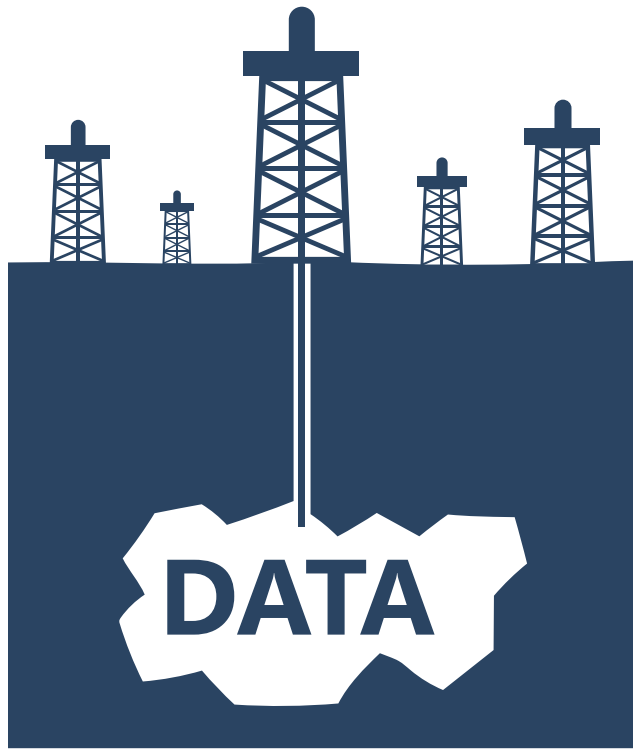
"Retail banks face two main trends, both accelerated by the Covid-19 lockdown," says Antony Jenkins, former chief executive of Barclays and now chief executive of 10x Future Technologies, a fintech start-up. "First, customers want a beautiful digital user experience. Second, there are cost pressures from low interest rates and rising credit losses."

Those two together, alongside a generational change at the top of banks, are making the industry "look much more seriously at radical solutions", says Jenkins. "They see that the only solution is to massively automate the bank."

Large-scale automation and radical technological solutions are required at incumbents because of their legacy technology. "Even when incumbent banks have a great front-end digital experience, it is a skin over a pile of software patches built up over many years," says Russak-Aminoach. "That is why it is so difficult for them to innovate."

But the industry has been talking about the need for banks to get away from clunky legacy systems for a long time. Has it finally reached a tipping point when old systems will be discontinued? It may have. Thought Machine, a company that provides core banking software, announced an £83m funding round in March 2020. It is increasing its headcount and said recently that the former chief operating officer of HSBC, Andy Maguire, would be joining it as president.

Meanwhile,10x Future Technologies has "only seen the number of inquiries" from banks increase during the recent lockdown, Jenkins says. "That is pretty much from everywhere, with slightly less demand from continental Europe."



What BigTech can do

BigTech companies do not have legacy back-end technology to overcome and they are, in any case, agile innovators. So, if Google were to enter the EMEA retail banking market with a Google-branded current account, what would that mean for EMEA retail banks? One argument has it that banks will become back-end utilities providing regulated banking functions behind a Google app.

> *"The danger is that banks get stuck with maintaining the infrastructure they used to need, such as branches*

"Will banks become utilities behind the financing offers of big tech platforms?" asks Paul Gordon, managing director SME and mid corporates within the commercial banking division of Lloyds Banking Group. "I think the way forward is for banks to do what they do really well, which, at its core, is to provide liquidity and payments. Banks can build a network with fintech partners who can help them do that brilliantly. Similarly, big tech companies should do what they do best and they probably won't want to expand their brands into many areas of retail and commercial banking, such as supporting customers in financial difficulty, or arrears, or debt collection."

Jenkins says: "The business that banks will be able to hang onto is balance sheet business, which is capital intensive and highly regulated. The danger is that they get stuck with maintaining the rest of the infrastructure they used to need, such as branches."

How much of a drag on profits a branch network can be is suggested by the symbolic €1 offer that investment firm Cerberus is reported to have recently made for the French retail arm of HSBC. The firm is also said to have asked HSBC to invest €500m into the 270-branch business. Banks did not bid for the retail network.

BigTech companies, then, will likely cherry-pick the services that can be digitalised and offload anything that requires more intensive, and potentially contentious, customer engagement. But can BigTech do anything that banks cannot?

Jenkins points out that the fundamental products in banking are as old as time. "The biggest driver [for a new entrant] is how to make the customer experience materially better." He adds that the banking industry over the years has not been deeply focused on the customer.

"It was much more on the manufacture and sale of products," says Jenkins. "And most of what they do is just providing data – for example, how much money is in a current account. It is possible that BigTech could create a layer of value to the end-customer by placing themselves between the bank and the consumer." That is not a new approach, he adds. "PayPal was set up to sit on top of the banking system."

Culture challenge

Many banks – both the incumbents and their fintech challengers – already offer a slick front end. How much of an inroad can a new current account app make, however good?

"If you can see a person's entire financial life, you could provide them with optimisation for many services, offering to switch to better deals in other sectors," says Jenkins.

And banks do have important factors going for them. "Financial data is an enormous advantage for banks," says Russak-Aminoach. But they need to be able to use it to offer a personalised product, she adds.

BigTech, in contrast, lacks direct access to financial data, but can offer very personalised service, based on many different data feeds from one consumer and on a deep insight into the market overall. Google, for example, owns Google Nest which offers "smart home products", including thermostats, speakers, doorbells, cameras and locks. All of those devices gather data – data that could be used to optimise other services, including financial offers.

But banks, too, can access a range of consumer data and the use of so-called "alternative data" is rising. How useful that "alternative" view can be has been shown by the Covid-19 crisis. Reuters reports that UK banks are using trends in internet searches, alongside traditional credit and payments analysis, to help them update their credit models. Online searches and social media feeds give the banks real-time and potentially forward-looking information on consumer sentiment. Their historical financial data, in contrast, is very detailed, but it only gives them a view of how things were before the crisis.

> *"For most people, managing their money is a challenging, somewhat tedious activity*

But getting to a point where banks utilise data as well as the BigTechs do could be a long road. "Mastering the technology is not beyond the ability of most banks," says Jenkins. "The problems are much more about culture, about the fear of the unknown and about the ability to move forward."

At the same time, consumers associate BigTech with excellent service – partly because it is constantly innovating. They do not tend to have a positive view of dealing with their bank. "For most people, managing their money is a challenging, somewhat tedious, activity," says Jenkins.

He believes people will want financial apps to make life as easy as possible for themselves. That, potentially, could mean they only use one banking app, if they are willing to feed the app with all the necessary data via open banking. "Open banking is predicated on the idea of consolidating data," says Jenkins. "It all comes down to 'does it make the customer's life easier?'."

So, could a BigTech such as Google become the go-to front end for most retail financial services, or will the digital experience remain fragmented? I'm not sure I know the answer," says Russak-Aminoach. "I think it will be fragmented, but not as fragmented as today. Acquiring customers is very expensive, so a one-product offer makes little sense." ■

Ouida Taaffe *is the editor of* Financial World

Getting to know you better

***Anthony Gandy** reports on how the switch to digital by insurance customers, and the wide range of available online data, could revitalise the bancassurance sector*

The Covid-19 crisis has been a good one for insurtech. It generated a huge shift towards the digital distribution of insurance. Swiss Re Institute reports that during the crisis "the sudden loss of face-to-face touchpoints in many markets resulted in overloaded call centres… many insurers were unable to satisfy their customers' needs".

That sudden acceleration in the shift to digital channels has been reflected in the valuation of insurtech propositions. For example, Lemonade, the SoftBank-backed digital home insurer, launched its IPO priced at US$29 a share on 2 July, 2020. On the first day of trading, it saw an intraday high of more than US$70. Lemonade, which is focused on reaching the customer through mobile devices and using chatbots and other digital tools, represents a new digital-from-the-ground-up insurance player.

Sara Costantini, director at CRIF Decision Solutions, which provides digital and artificial intelligence platforms to global insurers, believes the pandemic has accelerated the need for insurance to move to digital. "The pandemic has highlighted all the limits of traditional systems and touchpoints, and so banks/insurers have had to seek out new ways to re-engage with customers across all lines of business," she says. "The pandemic experience, by its very nature, has increased consumer propensity to interact and purchase services digitally, while there is also a heightened demand for insurance cover and financial services tailored to individual circumstances."

The digitalisation of insurance is a multifaceted event. It changes the way customers interact with their insurance providers but it also goes far deeper than a mobile interface. In particular, it emphasises the value of data and the intelligent use of that data. Insurers need to respond promptly to that, and potentially look to some old allies, the banks, to develop a more dynamic relationship with the customer.

Why insurtech will partner with banks

From the outside, the changes might not seem profound, but a look at car insurance shows the risks and opportunities that insurtech faces. Insurers have been offering telemetric solutions for car drivers for many years. Their black boxes track how the car is being driven and that data can be used to put together a much more personalised, and keenly priced, risk profile than that provided by traditional offline data, such as the gender and age of the driver. In the era of the Internet of Things, manufacturers of cars, white goods and many other products build data capabilities directly into their goods and services. Car manufacturers can use data from the sensors they install to provide adaptive, use-based insurance propositions to customers, either themselves or through chosen partners.

Car insurance is not the only front line for the industry. Consumers are increasingly using personal sensors such as Fitbits that provide data on their health, and installing sensors into their homes that can monitor factors like security and temperature. The sheer ubiquity of data sensors represents a big problem for traditional insurers. If they are not in that data loop, they could be disintermediated by firms that can make better risk assessments and provide a more personal service. The risk is very real.

> *"Traditional insurers could lose out to firms that make better risk assessments and provide a more personal service*

Swiss Re Institute reports that, on average, US insurers exchange data with customers 2.7 times a year. Insurers who rely on traditional sources of low-touch customer data are putting up barriers to potential online customers. Swiss Re Institute notes that when it comes to digital customers, "insurers have failed to meet this rise in expectations. Even simple insurance purchases require long questionnaires, lengthy assessments and channel-shifting, making it easier for BigTech interlopers."

Closing the gap

This digital challenge, and the general paucity of data that insurers on their own can collect about the risks and financial health of their customers, could revitalise the bancassurance model – or at least a virtual version of it. Banks have long been key sales channels for insurers in some regions. For example, in Italy nearly 80 per cent of life policies go through banks. In Spain and France, the figure is well over 60 per cent. But, in the UK, little life insurance business now goes through banks. There seems to be a failure to link the

information banks have on their customers to the insurance propositions. This is not just about increasing revenue; it could make a meaningful difference to customers.

History is littered with failed efforts to create tightly coupled bancassurance offerings. Evangelos Avramakis, head of digital ecosystems R&D at Swiss Re Institute, says: "We have not seen that many natural M&As between banks and insurance companies so far, especially not in Europe or the US, although there are a few limited exceptions." This seems to be the case. The mergers of Dresdner Bank with Allianz, and Citicorp with Travelers, did not produce integrated bancassurance powerhouses.

Avramakis says there is a fundamental cultural challenge in a marriage between insurers and banks: insurers focus on broad risk during a finite relationship with the customer, while banks focus on asset appreciation and look at risk related to that asset growth. But, from Finland to China, new digital bancassurance platforms that offer customers a joined-up, intelligent and digitally delivered financial package are beginning to develop. The key now is not simply channels to market, but data.

According to Avramakis: "The key topic to be addressed is financial health." This moves away from a view of a person's risks, liabilities and assets in isolation from one another towards a unified view of total financial well-being. It should create a transparent view of the total outlook for the customer. The question becomes: "How can you maximise already existing data sets in order to create value for the customer?" Banks interact with their customers much more frequently than insurers do and the data that generates on customers, behaviours and risks is a key source for insurers. They can tap into it to develop their stake in providing a total financial health service environment.

Avramakis says banks are in a strong position "because they're very good at the credit scoring and all score-related things". But he emphasises that credit-risk information is now spread out all over the place, especially on social media, and critical cues may be found elsewhere before the bank will know the transaction is taking place.

"This is important as there are some transactions that are very much related to insurance," says Avramakis. "For example, if somebody buys a mortgage, buys a car, or goes travelling, this is context." Bancassurance channels can build on this context and develop a wider financial health picture of the customer and start to develop bespoke and dynamic services for that person.

Tim Kunde, co-founder and managing director of Germany's Friendsurance, says: "Until now, insurers have only been acquainted with a small part of their customers' lives. They are not relevant in customers' day-to-day life and lack in-depth data on their needs and usage behaviour."

Friendsurance was launched 10 years ago as a peer-to-peer insurance provider and is now building bancassurance platforms. Kunde believes that banks are highly relevant in everyday life and have more access to customer data. If that data could be shared, both could benefit.

Until recently, the sharing of customer data between banks and insurers was restricted but the regulatory framework has changed. The EU's second Payment Services Directive (PSD2) has removed bank monopoly on account data. If the customer authorises insurers to access that data, they can use it. Kunde says that intelligent algorithms and machine learning can then be used to extract information from bank account transactions.

> *"Until now, insurers have lacked in-depth data on their customers' needs and usage behaviour*

There are strong arguments for insurers to reassess the value of the bancassurance route to market – focusing on a data-rich environment. But data is now generated in many locations and all financial services institutions face challenges from BigTech. In the past, banks were expected to be the first business to obtain data that a customer was buying a house and was likely to need insurance coverage for the new property. No more.

As Avramakis points out, online house brokers are the businesses most likely to notice this information first, and even social media companies are likely to see a house purchase before a bank. Accessing these cues will be essential for searching for new business. But bancassurance can protect its relationship with customers by mining both external cues and its wider customer contextual information. That will allow it to offer intelligent total financial health packages to customers and provide value that interlopers may not be able to offer.



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What's in the stars for Libra?

Facebook's digital currency should be operating by now. Will it ever go live? Or will it be beaten to market by central bank digital cash launches? ***Tim Green*** *reviews the evidence*

When Facebook chief executive Mark Zuckerberg appeared before the US Congress in October 2019 to explain his plans for the Libra digital currency, it took just 71 seconds for him to admit: "I'm sure people wish it was anyone but Facebook putting this idea forward."

Just a bit. Facebook's original motto for developers was "move fast and break things". It was fine for nerdy tech ideas, not so great for money. Congress went on the attack, echoing the withering tone of regulators ever since Libra was announced in June 2019.

The pushback proved too much for Libra Association members Stripe, Mastercard, Visa and Mercado Pago. They all dropped out, leaving the consortium with no payment representatives. There were never any banks on board. A year later, Libra has still not launched, and it has changed substantially. Let us recap.

> *The essential challenge for Libra is that it has to be a store of value, a means of payment and a unit of account*

In June 2019, Facebook published a white paper outlining plans for "a reliable digital currency and infrastructure that together can deliver on the promise of the internet of money". But Facebook would not own Libra. Instead, it would be controlled by a consortium of 28 members, each with an equal stake.

The big promise of Libra was to combine the benefits of cryptocurrency with the stability of fiat currency. Like bitcoin, it would sit on a blockchain and support near-instant payments anywhere in the world for virtually zero fees. Unlike bitcoin, it would have tangible value – as a stablecoin pegged to a basket of real-world assets (US dollar, euro, government bonds, etc).

Libra's announcement put the cat among the regulatory pigeons. "It has the potential to be extremely significant," Andrew Bailey, the then head of the Financial Conduct Authority, told a UK Treasury Committee on 25 June, 2019. "It does raise big issues for the public policy world… At the moment, I would have to say there is insufficient detail on it to really be able to understand what the business model is… We will have to engage very heavily…we're gearing up with the Treasury and the Bank of England (BoE)."

The essential challenge for Libra is that money has to be a store of value, a means of payment and a unit of account. Without the support of central banks, regulators and a liquid banking system, Libra cannot be money.

In April 2020, the project pivoted. Central banks in some regions feared Libra would be more stable than their own money. In such a situation, Libra would become a quasi-sovereign currency controlled by private companies. In response, the association devised a new plan to release several Libra stablecoins instead — each of them backed by a fiat currency.

Over the course of Libra's eventful journey, many people have asked: why is Facebook doing this? The official answer from the company itself is that it wants to make payments cheap and easy for the unbanked and the underbanked. And with 3.14bn people registered on Facebook, WhatsApp, Instagram or Messenger, it would be in a good position to facilitate this.

David Marcus, vice-president of messaging products at Facebook, told CNBC: "The status quo of the financial system does not work for a lot of people. It is like telecoms in the pre-internet era. We were all paying a dollar a minute for international calls and now calls are free for anyone with a US$30 smartphone. That has not happened with financial services."

Marcus, formerly president of PayPal, argued that Libra had to create a quasi-digital currency to solve this problem. "The current system is not interoperable. You still cannot send money between PayPal and Venmo. You cannot cut costs and lower barriers of access for millions of people using the current system. Otherwise it would have already been done...You have to change the core of the system that moves money around."

That is a valid – even altruistic – reason. But, as Ajay Banga, chief executive of Mastercard, pointed out in an interview with the *Financial Times*, financial systems have to be compliant with local financial regulations. Banga said that Libra was reluctant to commit to that. He was also

concerned about how, exactly, Libra would make money. For those reasons, Mastercard withdrew from the Libra consortium.

Which brings us to the incentive for launching Libra. There seem to be two possibilities. The first is to keep people inside the Facebook universe. People will not delete their Facebook ID if it is inextricably linked to their ability to pay. And if they stay on the network, Facebook can keep generating data insights that it can sell to advertisers.

> *Libra has changed the debate about cryptocurrencies from theory to 'how do we make this work?'*

But if you have to be on Facebook to use Libra, that undermines the case for financial inclusion. It also raises the question whether advertising revenues are all Facebook wants. Bill Barhydt, chief executive and founder of Abra, a bitcoin trading app, says: "Facebook already has a low revenue per user and as it expands outside the US, it is only going to get worse. The best chance to fix that is transactional revenue."

Barhydt is enthusiastic about Libra and is sure the project will go live. He thinks the biggest hurdle is not regulatory approval or technical design, it is "money-in, money-out". That is, Libra's link to local currencies and to cash. He says: "What value can Facebook add to cross-border payment compared with what is out there today? The biggest is integrating it into WhatsApp. But if it is hard to get the money in and out, no one is going to use it. This is the single biggest challenge for Facebook."

Whatever the merits or otherwise of Facebook's approach, it has stimulated interest in cryptocurrencies – not least from central banks. James Wester, research director for worldwide blockchain strategies at IDC, a tech research company, says: "Libra has made the conversation go from theory to 'how do we make this work?'."

In January 2020, the Bank for International Settlements (BIS) revealed the extent of central bank activity. It estimated 80 per cent of central banks were investigating digital currencies – and around 40 per cent were either experimenting with central bank digital currencies (CBDCs) or running pilots.

On 9 October, 2020, BIS went further, publishing a report that laid out the "foundational principles and core features" of a launch. The paper focused on retail payments and identified three key principles for a CBDC: co-existing with cash and other types of money; supporting "wider policy objectives" with no threat to monetary and financial stability; and boosting innovation and efficiency.

The report gave further legitimacy to the CBDC concept. And given that the central banks working with BIS on its recommendations were the Bank of Canada, the BoE, the Bank of Japan, the European Central Bank, the Federal Reserve, the Swedish central bank Sveriges Riksbank and the Swiss National Bank, global momentum looks increasingly likely.



That leads to the question: what is the central banks' motivation? Why launch a CBDC? The Brookings Institution, a policy research specialist, lists five main benefits:

- efficiency: CBDCs lower the cost and increase the speed of transactions
- broader tax base: CBDCs can limit tax evasion and inhibit the use of cash for illicit purposes
- flexible monetary policy: CBDCs could give central banks direct access to digital wallets and, therefore, more power to affect fiscal outcomes

- payment backstop: CBDCs could counter privately managed payment systems, mitigating the risk of collapse in times of crisis and
- financial inclusion: CBDCs could make it easier to bring digital payments to the unbanked and underbanked.

All this activity could impact on the current card payment schemes. In the spirit of "if you can't beat them, join them", card providers have wasted little time moving into the space. In September 2020, Mastercard announced a virtual sandbox in which central banks could simulate the issuance, distribution and exchange of CBDCs between banks, financial services providers and consumers.

For its part, Visa filed a patent for a "digital fiat currency" to operate on blockchain technology. Cuy Sheffield, Visa's head of cryptocurrency, believes the company has no choice. He says: "CBDC is one of the most important trends for the future of money and payments over the next decade.. Whether it's good or bad, global interest in it is not going away."

Wester believes the card schemes are carving a new role for themselves in an era of instant transactions and virtually zero fees. "Tech is moving us to a place where you can't charge for moving money," he says. "So Mastercard and Visa want to be involved in the on and off ramps. They want to sell the aggregated data insights and connect the end points. And this is not just for payments between people but for transactions by things too. There's a huge market coming for Internet of Things payments."

Could the other tech giants follow Facebook down the cryptocurrency path? Google and Apple might have launched payments products but both Google Pay and Apple Pay sit firmly inside the rails of existing banking infrastructure. Their interest seems to be in getting a full view of consumer data, not in being financial services providers.

> *Tech is moving to a place where you can't charge for moving money...*

Apple has even been openly critical of Facebook's digital currency plans. Shortly after Facebook first announced Libra, Apple chief executive Tim Cook made his feelings clear. "I really think a currency should stay in the hands of countries," he said. "A private company should not be looking to gain power this way." It seems safe to assume Apple will not be joining the Libra Association. ■



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Brexit and the City

David Thomas examines what the EU wants for its financial services sector post-Brexit and what its increasing focus on European interests will mean for the City of London

EU–UK talks on a post-Brexit Free Trade Agreement have long been bumpy but now the endgame is becoming acrimonious. What may be worse is that Brussels' attitude towards the City of London is increasingly becoming "take-no-hostages".

"Brexiters like to say that Brexit is about taking back control. Maybe the EU wants to take back control too?" says Jacques Lafitte, a former senior European Commission official and now chief executive of Brussels-based consultants Avisa Partners.

"There was a view in 2016-17 that maybe something could be saved with the Brits. I think, at the time, joining the European Free Trade Association was being considered or even access to the Single Market. But look where we are now," he adds, summing up the bitter backdrop to the EU's new firmer line.

> *There is political muscle behind the EU's push but political will is one thing and business rationale another*

The EU has given the City an 18-month respite on relocating clearing of euro-denominated derivatives to the eurozone, but it's not a reprieve. EU officials only want to ensure financial market stability in the potentially volatile weeks and months ahead.

"London has a [euro-derivatives clearing] market share of 90 per cent. No one in the eurozone is really ready yet – you can't just flip a switch," says an EU source close to the discussion at the European Commission and the European Central Bank. "But after the 18-month additional period, [clearing] must be done in a eurozone country."

There's also political muscle behind the push. Emmanuel Macron, the French president, and Angela Merkel, the German chancellor, are said to be convinced of the strategic necessity of having the clearing of euro instruments located in the eurozone. But political will is one thing and business rationale another. Banks don't have an incentive to switch to eurozone clearers. The London clearers have the scale to offer more counterparties and more liquidity, which means lower costs and tailored deals.

More importantly, at a time of low growth and economic crisis, making financial intermediation harder doesn't sound like a good idea. Why, then, are European governments going to force euro-asset clearers to locate in the eurozone?

An army, a flag and an exchange

Financial exchanges used to be the physical locations where trading was done. John Thain, former chief executive of the New York Stock Exchange, once said that every country has "an army, a flag and an exchange". Now financial exchanges are global technology companies that control financial infrastructure and shape the markets cross-border.

That's why the location of clearing houses is considered strategic. It's also why the European Commission is taking a hard look at the proposed takeover of Refinitiv, a US data company, by the London Stock Exchange (LSE). To try to get anti-trust agreement, the LSE has agreed to sell Borsa Italiana, Italy's stock exchange. With Borsa Italiana, it would have a quasi-monopoly on European government bond trading. But even given the sale of Borsa Italiana, the deal faces hurdles.

"LSE will face a hard fight and that is in part due to the way in which the UK government's behaviour over Brexit has poisoned the atmosphere," one source says.

Going it alone

European officials say the UK dropped demands for unfettered access to European financial markets back in July when the EU made clear that it would entail membership of the EU's Single Market.

The UK is now seeking 'equivalent' third-country status. But equivalence is in the gift of the European Commission, with just a three-month notice period. And talks between the UK and EU on equivalence have been stop-start, with the Commission accusing the UK of providing inadequate information in response to detailed questionnaires. The upshot is that, as of mid-October, equivalence status is currently not on the table.

Instead, the EU's goal seems to be 'strategic autonomy' in capital markets. This is partly to do with the way Covid-19

has highlighted the dangers of not being self-sufficient in key sectors, such as healthcare, digital and raw materials, in an increasingly protectionist world.

"There's a strong political will in the EU to be less dependent, not just on London, but also on the US and the dollar," says Peter Praet, former European Central Bank chief economist and a member of the Capital Markets Union High-Level Expert Group. "The EU has become much more convinced of the urgency of having its own, robust capital markets. That also means the EU becoming a global standard setter in the financial sector and necessitates a single supervisor at the EU level."

But if Capital Markets Union (CMU) is really to challenge London and achieve its aims, there are many small, yet important, nitty gritty issues to sort out. One good example, Praet says, is the EU withholding tax. While cross-border rebates on the tax are available, claiming it back generally involves administrative costs. "Yes, it's peanuts, but there are a lot of peanuts involved in achieving Capital Markets Union."

> *Some eurozone countries see a once-in-a-lifetime opportunity to grow big at the expense of London*

Bright lights, big City

Even if eurozone members can agree on all the fine print, some are sceptical that the EU can steal London's finance crown. They also don't believe a cut-throat competition with the City is the best strategy.

"We still want and need to maintain bridges," says Nicolas Mackel, chief executive of Luxembourg for Finance, an agency that promotes Luxembourg's financial centre. "We will never rejoice about Brexit. We can't look at London like it's Canada, Japan or Korea. For 47 years, the UK grew very deep roots with our economies. We can't pretend those don't exist." But he admits that "other countries see a once-in-a-lifetime opportunity to grow big at the expense of London".

The main reason why Luxembourg sees London as vital is that the financial centres in Paris and Frankfurt were built to serve their own domestic economies and to support their own blue-chip companies in issuing debt and stocks. For international business, big French and German companies always turned to Luxembourg and – essentially – the



City of London. The City is where international financial infrastructure at scale is located in Europe.

But Brexit clearly seems to offer an opportunity to Paris and Frankfurt to take share from the City. Can they grasp it?

"Each centre will gain in importance, but not enormously," says Mackel. "Nowhere will it be a game changer. Paris and Frankfurt will probably acquire an international dimension to add to their domestic activity."

London has international standing partly because it radically deregulated its domestic financial markets nearly 40 years ago in the "Big Bang". Europe still has many parochial practices. "We really need a Big Bang, but do we have that level of ambition in Europe?" asks one observer, who is close to the Capital Markets Union dossier.

He also says Brexit may not be bad for the City. "London might lose control of the Continent, but it would have a much more adaptive and flexible legal framework when facing the rest of the world," he says. "Rather than equivalence, and all the compliance burden that it brings, being alone and unencumbered may be a better strategy for an international global financial centre." ■



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The commodity of trust

Ouida Taaffe explains how fraud sparked a wider shake-up in commodity trade finance and looks at what the future holds for the sector

Because trade finance is short-term and collateralised, it has long been a low-risk business. Between 2008 and 2011, when many companies were suffering from the global financial crisis, the average default rate per transaction for large banks in short-term trade finance was 0.02 per cent. During the same period, the average loss rate was 0.01 per cent, according to the International Chamber of Commerce.

The loss rates stayed low even as the world economy and trade finance grew. China became a member of the World Trade Organisation in 2001, turbo-charging globalisation and the commodities super-cycle. In the five years to 2008, the real prices of energy and metals more than doubled, according to a 2012 research paper by Bilge Erten and José Antonio Ocampo: 'Super-cycles of Commodity Prices since the Mid-Nineteenth Century'. During the same period, the real price of food commodities increased by 75 per cent.

When the global economy contracted after the global financial crisis of 2008, commodity prices fell, but they soon came roaring back, at least until recently. Why then are ABN Amro, BNP Paribas, Rabobank and Société Générale all either re-evaluating or exiting commodity trade finance?

Who's trading naked?

The primary trigger for the shake-out in commodity trade finance was fraud. The collapse of the oil trader Hin Leong in Singapore in April 2020, which cost banks more than $3.5bn, is one of a number of scandals that have chilled bank enthusiasm for commodity trade finance. Hin Leong was not alone in pledging the same collateral to several banks.

Gianluca Romeo, director, primary rating analyst at Fitch, the credit rating agency, notes: "Trade finance exposure is typically concentrated in a relatively small number of counterparties so, until banks see sectoral defaults, they can have a false perception that their risk is limited."

Dominic Broom, chief executive of Fineon Exchange, a trade finance platform, says: "What fraud cases often demonstrate is that, unwittingly, some banks do not have collateral. The answer is not more regulation, but more transparency through digital traceability of goods."

Fraud is not the only problem that commodity trade finance faces and that regulation struggles to address. The oil price and the Covid-19 pandemic have also made banks take a harder look at their strategy in trade finance.

"I believe it is fair to say that in the middle of a crisis – and the pandemic combined with the oil price shock earlier this year [2020] was a double hit for the commodity industry and its lenders – stakeholders have become more cautious," says Sandra Primiero, global head of natural resource finance at Deutsche Bank. "But we see a continued willingness to finance clients in the commodity industry."

Marc Auboin, economic counsellor at the World Trade Organisation, points out on a recent podcast that, historically, trade finance is structured around a few colonial banks, so the banking network is "overgrown in terms of core clients". At the same time, Asian banks have entered the market and gained share.

> *"Tightening the rules won't be effective without an international framework to check the life cycle of a trade*

The start of a broader reset?

Is this the start of a broader reset in commodity trade finance? "The difficulty is that all banks assess risk in the same fashion," says Jean-Francois Lambert, founding partner of Lambert Commodities, a trade finance consultancy. "So it all depends on their respective return on risked capital. Risk has gone up in commodity trade finance, so every bank will be compelled to reassess its strategy." He points out that banks such as ABN Amro and BNP Paribas have been active in commodity trade finance for a long time "so their exit is definitely a concern and a wake-up call".

Lambert says that what drives the uniformity of approach at trade finance banks is regulation. "Once regulators start asking questions, all banks will be compelled to review their portfolios as the risk perception has gone up," he says. "The end effect will be that many of them will tell their regulator they are going to shrink commodity trade finance at least a bit."

That raises the question of whether the attitude of regulators to commodity trade finance will change. "I would

expect a tightening of regulations," Romeo says, "but it won't be effective if it's not accompanied by an international framework that can check the entire life cycle of a trade. For example, the derivatives market has a standard framework set out by the International Swaps and Derivatives Association."

But even if regulation compels banks to re-examine their commodity trade finance business, the outcome need not be an exit. "The good news is that some banks have, in terms of absolute numbers, a very profitable commodity trade finance business," says Lambert.

> *Trade finance needs expertise and a network of banks. It sounds like a plain vanilla business, but it's not*

That may be why there are reports of new trade banks, from China and capital-rich regions such as the Middle East, and of increased opportunity for existing players. "We see some banks becoming more active, and the commodity finance market is de facto very fragmented," says Primiero. "It's too early to say whether this is an ongoing trend or partially to support local economies. But trade finance requires expertise and a network of banks. It sounds very much like a plain vanilla business, but it's not."

She points out that barriers to entry will make it difficult for new partners to enter the market, and that is before they deal with all the local and global regulatory requirements.

Supply chains reshaped in Asia

Asia is home to 60 per cent of the world's population, so it has a central role in commodities. China alone accounts for over 50 per cent of the world's demand for metals and it is the second largest user of oil globally. But China is also an important commodity exporter. For example, it is the world's largest producer of phosphates.

As a region overall, Asia has long had a relatively heavy reliance on trade finance. Research from the Bank for International Settlements says that in 2011, Asia accounted for more than half of overall trade finance exposures, but only around 35 per cent of merchandise trade.

Why is trade finance used more in Asia? The Bank for International Settlements suggests some reasons, including longer supply chains, new trading relationships and weaker contract enforcement in some Asian countries. But it points out that those factors also apply to South America,



which doesn't show the same heavy use of trade finance. Other reasons involve differences in regulation and legal frameworks. Letters of credit, for example, can be a cheap way to finance working capital in some Asian countries.

But global supply chains are undergoing a "tectonic shift", according to research from Bank of America. More than 80 per cent of the 12 global sectors it surveyed are moving at least some supply chains to other locations. That will include reshoring, moving out of China and more. This is because of factors such as tariffs, national security, ESG (environmental, social and corporate governance) concerns and a fall in the labour cost differential between emerging market countries and elsewhere because of increasing automation. And that is before Covid-19 makes people examine the potential fragility of long supply chains.

What all of that will mean for commodity trade finance in Asia is still in flux, but it seems clear that fintech will be an increasing part of the solution.

The paper trail goes cold

The pandemic lockdown has shone a harsh light on many things, including the documentation of trade finance. There have been calls for many years to change the sector's reliance on paper but little movement, mainly because change demands global coordination.

When Covid-19 suddenly made it impossible physically to deliver trade documents, digital communication was the only solution. Banks devised work-arounds, based on trust, and also found an increased zeal for digitalisation. Changes to the Bills of Exchange Act, to allow edocs in trade finance to be treated as negotiable instruments, now look feasible within two years. Given that English law underpins much of global trade, that would be a big breakthrough. Before the crisis, people talked about a much longer time frame.

The reason why the digitalisation of trade finance is both a great prize and a huge challenge is only partly to do with the current legal requirements to have paper documentation and wet signatures. The sector is also complex, with many rules. Getting it right means knowing your customer (KYC) and your customer's customer. It's about tracking and tracing and checking, and about the ability to enforce contracts globally. That means a lot of moving parts.

"The issues that have arisen in commodity trade finance highlight the need for robust KYC and business processes," says Broom. "Where institutions have fallen foul of fraud, it was because they didn't have full visibility over the underlying transactions."

He says it's possible to track collateral, "although not at all times". "There are trusted agents at all ports and specialist firms that undertake warehouse assessments. You just can't take shortcuts if you want to be sure that the promised collateral is your collateral."

Fintech in trade finance

Technology holds out the promise of bringing transparency and traceability to trade finance. Platforms such as Trusple (a contraction of "trust made simple"), which was launched in September 2020, produce a smart contract that digitally "collects" and verifies the information it needs. It is run by Ant Financial, the Chinese technology giant, on its proprietary blockchain technology, Antchain. Its bank partners include BNP Paribas, Citi, DBS, Deutsche Bank and Standard Chartered.

Trusple is one of several blockchain initiatives in trade finance. Contour, which aims to be the first global trade finance network, linking buyers, suppliers and banks across all geographies and industries, went live on 5 October, 2020. It lists 16 bank partners, among them Citi, HSBC and Standard Chartered.

But can technology conjure away the challenges of commodity trade finance? They are, after all, global – and sovereign entities are involved. The Monetary Authority of Singapore, for example, is in talks with the Hong Kong Monetary Authority on digitalising trade between the two cities. Singapore launched its own Networked Trade Platform in 2018 and is looking at changing its legal framework to allow some edocs to be treated as negotiable instruments. Many jurisdictions are likely to want their platform and rules to be central.

> *"Where banks have fallen foul of fraud, it was because they didn't have full visibility over the underlying transactions*

Some commodities are also potential flashpoints in themselves. Demand for cobalt, for example, which is used in lithium-ion batteries, is expected to grow sharply and countries are stockpiling it because few can mine it in sufficient quantities. Around half of global reserves are in the Democratic Republic of the Congo.

The need for commodity trade banks will not go away any time soon but the question is whether banks must be in commodity trade finance to be well-positioned in trade finance more widely.

Primiero says: "There is no strict 'must' in my view. But which business in the real economy can cope without commodities? You need aluminium for wind turbines, steel for machines, energy for production and heating, etc. Consequently, as long as you finance companies, financing the trade flow of commodities from and to them should form an integral part of a bank's product offering." ■

Ouida Taaffe *is the editor of* Financial World

The rage within the machine

***Paul Wallace** discusses how machine learning allows the financial sector to make better predictions but can also cause worrying side effects, such as market 'flash crashes'*

Artificial intelligence (AI) is an old idea but is fast becoming a new reality, particularly through its lovechild, machine learning. Machine learning allows developers to take much of the grunt work out of programming because machine learning algorithms can be "trained" to find patterns and relationships in huge amounts of data, instead of being explicitly programmed. The resulting analytical models can be used to make decisions and predictions based on new data. An oft-cited example is the self-driving car.

In finance, potential and actual applications of the technology abound, offering both new services and cost savings in bread-and-butter business. Central bankers and regulators can also benefit, as machine learning better informs policies. They may need all the help that they can get because there will be plenty of pitfalls, too. That is because the new technology threatens to create fresh stresses and fragilities in the financial system.

By marrying big data with computational clout to transform the prediction business, machine learning both improves forecasting and reduces its cost. It also extends it to new fields. The theoretical potential of this branch of AI has long been recognised. What has made it practicable in recent years is the explosion in the sheer volume of data online and the fall in price of the computing power needed to wrestle down that data. Cloud technology, in particular, has been transformational. It breaks open in-house data silos and lets companies easily scale up computing without huge fixed costs. That has sparked a modern gold rush, with over half of all AI patents filed since 2013, according to the World Intellectual Property Organisation.

> *"Machine learning can be useful in helping banks to detect fraud and counter money laundering*

Since the raw material of finance is data – used to take positions in markets, to extend loans to creditworthy businesses and individuals, or to underwrite insurance policies – it is a fertile field for machine learning. Sophisticated algorithms can be developed to pinpoint profit opportunities that might not have been visible before. Early adopters have been specialist hedge funds such as D.E. Shaw, a pioneer in "quant" investing, whose eponymous founder and computer scientist told the US business magazine *Fortune* in 1996 that "finance is really a wonderfully pure information-processing business".

Machine learning has been slower to affect mainstream financial activities but this is now changing. According to a survey of firms in 2019 by the Bank of England and the Financial Conduct Authority, two-thirds were using such techniques, especially in the banking and insurance sectors. Machine learning is particularly useful in helping banks to detect fraud and to counter money laundering. In its guise as chatbots, it can also answer simple queries from customers without expensive human intervention. According to David Bholat, who leads a team working in advanced analytics at the Bank of England, there is also particular interest in using the techniques to automate regulatory reporting and compliance.

Banks have been using computers to cut costs since the 1960s but the potential for machine learning goes much further. All companies store data in structured files – databases that are easy for computers to analyse. The new techniques can also be used to interrogate unstructured data sets, such as images or text, which are a much harder computational nut to crack – and which also represent the majority of data. That can yield fresh analytical insights to improve existing services, such as through better personalisation for customers, and to suggest new product offerings.

By tapping into whole new data sets and analysing them in fresh ways, machine learning could reshape the ecology of UK finance, although this is by no means a foregone conclusion. For outsiders, it offers an opportunity to identify and peel away clients that are more profitable than conventional modelling showed. For example, traditional credit scores exclude many people who are actually a good bet. New entrants can also be nimbler because they are not burdened by legacy systems. On the other hand, incumbents are sitting on troves of data, which can be harvested more effectively through the new technology.

The challenge for the regulator

Central banks and regulators are having to move fast to keep up with machine learning, not least to find out what their charges are up to. The Bank of England has established a data and analytics department, which is exploring the potential of the new technology to improve its work in monetary and financial stability. At a virtual conference in March 2020, it set out examples of this work, such as an indicator of sentiment based on newspaper text, which outperformed traditional survey-based measures for forecasting purposes. Moreover, when applied to data for the UK, from the run-up to and during the financial and euro crises, a machine-learning technique called "random forest" outperformed conventional statistical approaches in providing an early warning of banks running into trouble.

One snag in these apparently promising findings is that they emerge from a "black box". Gains in performance may be real but they come at the loss of transparency. Findings and predictions can confound conventional intuitions as the new approach finds unexpected patterns in the data. It can do that thanks to complex data interactions and non-linear relationships. Although techniques are being developed to try to explain the findings, this constrains the use of the results among decision-makers – whether they work for financial firms or regulators – who have to formulate and defend policies.

There are broader worries about possible side effects when machine learning is applied in financial markets. Algorithms may outperform humans at divining profitable opportunities from the data fed into them, but that can leave their users exposed if that information fails to encompass the full range of risks. Algorithmic trading has been "flash crashes". These have become increasingly common in the past decade, affecting equity, bond and currency markets. At the start of 2019, for instance, there was a sudden and violent appreciation of the yen during early trading in the Far East. Subsequent analysis by the Reserve Bank of Australia suggested that algorithmic trading strategies might have acted as "amplifiers" in this episode.

In an even more worrying example, the US Treasury market, which underpins not just government debt markets but all kinds of securities around the world, started to malfunction in the spring of 2020. Algorithms used by high-speed trading funds, which exploit minute arbitrage opportunities between Treasury bonds and their corresponding futures, and involve massive leverage, backfired in March because of the "dash for cash" in the Covid-19 panic. The Federal Reserve had to intervene to restore order – by injecting massive liquidity (and yet more moral hazard) into the markets.

As the use of algorithms spreads, the danger is that they exacerbate trigger-happy markets and herding behaviour. Given that they probably use similar data sets and machine-learning techniques, they are likely to reach similar conclusions, executed at speed if the trades are automated. As Jon Danielsson, of the London School of Economics, points out, the result will be crowded trades, with AI engines updating in a similar way and all wanting either to buy or to sell the same assets, at the same time. That may first push up markets too high and then lead to sudden collapses.

> *Wider use of algorithms risks exacerbating trigger-happy markets and herding behaviour*

For all the apparent potential of machine learning to reshape finance, it may turn out to be not such a mould-breaker for the UK's big retail banks, which have, after all, withstood previous technological threats. Pru's Egg offers a parable. Laid by the insurance giant in the dotcom boom, the internet bank hatched losses rather than a viable business and Prudential discarded it a few years later.

Though technology has moved on a lot in the last 20 years, the UK's big banks still dominate retail and business banking. That is despite the fact that their hegemony was founded on branch networks that are becoming increasingly redundant. Banks moan about the burden of regulation, but it acts as a barrier to intruders.

The biggest danger AI poses to financial services is in the impact of machine learning on markets and the financial system as a whole. Regulators have laboured mightily to try to avoid another global banking crisis, above all by insisting that banks hold much more capital. But that very response means that the next threat is likely to come from another less regulated quarter.

The promise of machine learning is better prediction. Paradoxically, that could result in greater unpredictability in financial markets. ■



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Does it pay to go green?

***George Graham** discusses whether ESG investments deliver higher performance or lower risk than purely financial ones*

The arrival of coronavirus in 2020 has provided a stark reminder that climate change isn't the only risk institutional asset owners face. Covid-19 has arguably pushed the "social" element of Environmental, Social and Corporate Governance (ESG) investing to the fore, as companies come under the spotlight for the ways they treat their staff. The pandemic stock market turmoil has also provided something of a natural stress test for claims that investment strategies that incorporate ESG deliver higher performance or lower risk than more purely financial ones.

What has the experience taught us? An incontestable fact is that ESG strategies are a definite positive for asset managers (as opposed to asset owners). The past two years have seen substantial inflows into funds with some form of ESG purpose, ranging from negative or exclusionary screening to impact investment. The Global Sustainable Investment Alliance estimated that total sustainable invested assets in Europe, the US, Canada, Japan, Australia and New Zealand stood at $30.7tn at the start of 2018. That had risen by a third in two years and the figure is expected to grow to at least $40tn by the end of 2020.

Surprisingly, the indications are that momentum was sustained even in the tumultuous first quarter of 2020. Data from Morningstar, the US investment research firm, show that inflows into US sustainable funds reached a record $10.5bn in the first quarter. Even March, which spanned the stock market trough, showed net positive inflows, although investors withdrew money from fixed-income sustainable funds. Three-quarters of these inflows went into exchange-traded funds and indexed funds.

In the early months of lockdown, some in the industry were quick to claim that sustainable investment strategies were demonstrating higher returns alongside higher inflows. Academic studies found evidence that investors differentiated between potential investments based on their human capital, supply chain, and products and service response. Researchers at Harvard Business School analysed news coverage of corporate responses to the coronavirus and found better share price performance for companies that were seen as having demonstrated more commitment to their staff and stakeholders.

Meanwhile, the European Corporate Governance Institute found higher returns, lower return volatility and higher operating profit margins during the first quarter of 2020 for companies with higher environmental and social ratings. Morningstar found that sustainable funds not only outperformed others in that period but also held on to most of that outperformance through the second quarter. In the first half of the year, 72 per cent of sustainable equity funds ranked in the top halves of their Morningstar categories. All 26 ESG index funds outperformed their conventional index-fund counterparts.

> *"Companies that showed more commitment to their staff and shareholders had a better share price performance*

More recent studies have pushed back against this optimistic reading. First-quarter stock market falls were particularly acute in the energy sector, where ESG funds are typically underweight. In the second quarter, the bounce-back was heavily tilted towards large technology stocks, generally an ESG overweight. Researchers at Stern School of Business found no evidence for ESG outperformance, once you control for industry sector and financial structure.



Where does that leave asset owners who are puzzled by whether they should incorporate ESG considerations into their investment strategies? And, if they do, how should they go ahead?

A first point is that, whether they want to or not, pension funds are now obliged to pay some attention to ESG factors. Defined benefit schemes in the UK were required to publish their Statement of Investment Principles by October 2020. The statements must disclose their policies in relation to "financially material considerations over the appropriate time horizon of their investments" – a somewhat weaselly formulation intended to drive climate risk up the agenda without overtly steering trustees' investment decisions.

> *"Evidence is mounting that the more ESG data companies put out, the more the ratings diverge*

Consultation also closed in October on requirements, which will be included in the Pension Schemes Bill, for pension schemes to report in detail on their assessment and management of climate risks and opportunities. This could include a requirement to calculate a fund's carbon footprint and to assess how the value of its assets and liabilities would be affected by different temperature rise scenarios.

A second point is not to overpromise on the performance benefits of ESG investment. Richard Kersley, head of global equity research at Credit Suisse, says: "For those relying on ESG screening to enhance returns and reduce risk, there is a vast literature with sometimes conflicting results, depending on time horizons and approaches taken. However, long-term evidence dating back more than 20 years finds no conclusive evidence of [enhanced returns and lower risk]. This is in part due to lack of consistent data and universal agreement on what defines E, S and G, or perhaps it is a logical reflection of efficient markets. However, neither does there seem to be a high price to be paid for ethical principles."

Third, standardised rating approaches are unlikely to come to the institutional investor's aid – although this is the approach that the UK government's reporting requirements will inevitably drive. The inconsistencies between ratings provided by major agencies such as Sustainalytics, MSCI and FTSE are notorious, with virtually no agreement between them, particularly on governance. Worse, the evidence is mounting that the more ESG data companies put out, the more the ratings diverge. Researchers at Harvard



Business School argue that the subjective nature of most of the metrics means that more disclosure simply expands opportunities for different interpretations of information.

Finally, none of this detracts from the basic disciplines trustees are likely to follow when selecting managers – perhaps particularly so for credit mandates. After all, would you want to appoint a manager who might buy long-dated oil company bonds without fully exploring the long-term risks to its assets or business model? Nor does it weaken the potential value from engaging with investee companies to seek changes.

As Aswath Damodaran, professor of finance at the NYU Stern School of Business, concludes: "If there is a hopeful note for ESG investing, it is in the payoff to being early to the ESG game. Investors who are ahead of markets in assessing how corporate behaviour, good or bad, will play out in performance or price will be able to earn excess returns, and if they can affect the change, by being activist, can benefit even more." ■



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Spectre of stagflation looms as Fed's goals shift

Jamie Dannhauser explains why the Fed's recent change in monetary policy is a watershed moment and could mean 1970s stagflation will return to haunt the world

Over the past 18 months, the Federal Reserve has conducted an extensive review of its monetary policy framework. The end result is a decisive shift in Fed strategy. Within the investment community, this has generated much excitement. But is that excitement justified? And what will this strategic shift mean for monetary policy and financial markets outside the US?

Flexible friends

For much of the past three decades, central banks have practised what is commonly described as "flexible inflation targeting". The detailed aims and tools have differed across central banks but the basic strategy was the same: focus on price stability and a numerical target for inflation; accept that monetary policy can only achieve its aims over the medium-run; and, subject to the price stability objective, look to keep the "real economy" – output and employment – as close to full health as possible.

History is important here. "Inflation targeting" emerged from the monetary chaos of the 1970s. Then, high and volatile inflation was the enemy that had to be vanquished. The underlying problem was the inherent inflationary bias of a system where interest rates were set by politicians and finance was no longer disciplined by the Bretton Woods exchange rate regime.

The solution, beyond a focus on low inflation, had two further elements. First, policymakers wanted to depoliticise monetary policy by making central banks operationally independent. Politicians would no longer be able to use monetary policy to drive votes. Second, they made a strategic choice to accept Milton Friedman's dictum that monetary policy operates "with long and variable lags". That is, they moved interest rates well in advance of expected changes in inflation.

Fast forward to today and the spectre of high inflation no longer frightens monetary policymakers. They are haunted by the opposite problem: entrenched below-target inflation and limited policy firepower.

They are out of bullets for two reasons. One, nominal interest rates cannot go below zero (or very much below zero) and, two, inflation is structurally low: real interest rates can't fall much further. (To get the real interest rate, subtract the rate of expected inflation from the nominal interest rate.) That means there is limited room to loosen policy in recessions. In that situation, persistently depressed inflation can become self-reinforcing. These problems are compounded by the secular decline in the "neutral" interest rate, that is the reference point for where real interest rates must be set to boost or retard economic growth. In short, central bankers are now fighting a very different enemy to rampant inflation and they are doing that on unexplored terrain.

> *Central banks are fighting a different enemy to rampant inflation and they are doing so with limited firepower*

The Fed's new monetary policy strategy reflects these changed circumstances. But it is important to stress two things. First, the recent announcements are nothing more than a formalisation of Fed policy under Jay Powell's stewardship. Second, even before the review started, there had already been a marked shift in policy strategy away from the one that prevailed before the Global Financial Crisis. The shift was initiated during Ben Bernanke's tenure and continued under his successor, Janet Yellen. And the "flexible inflation targeting" regime has itself evolved alongside changing economic and political circumstances.

How central banks respond

That evolution is common to all the main central banks, including the Bank of England, and it heralds three critical changes in how policy will operate in the years ahead.

First, narrowly defined price stability will no longer be the dominant objective of monetary policy. That is not to say that central bankers will subordinate low and stable inflation to other aims. What it does mean is that price stability as a policy target will be defined in a more nebulous manner. In practice, it will sit alongside other objectives that central bankers feel

are worth pursuing, including goals that are judged to be necessary for reasons of political economy.

Second, the perceived danger that now drives policy is deflation. That is an about-turn. For much of the period after the 1970s, the overarching fear was of inflation rising above target and accelerating out of control. So, setting policy to avoid the deflationary abyss is uncharted territory. That uncertainty about what the future holds means policy must err on the side of doing too much.

Third, because of structural changes in the economy, there is a much weaker, if not entirely absent, case for pre-emptively tightening monetary policy as the unemployment rate gets close to its long-run sustainable level. This has been a central tenet of forward-looking inflation targeting. No more, it would appear.

Goodbye Mr Phillips

What is the logical basis for this change in inflation targeting?

In economics, the so-called "Phillips curve" is the argument that as unemployment falls, inflation tends to increase and vice versa. According to that, policymakers should set an interest rate that keeps the economy not too hot and not too cold. You warm up demand – and also employment and inflation – by lowering interest rates. You cool inflation – and employment and demand – by increasing interest rates. But the link assumed by the Phillips curve, between "slack" in the economy and inflationary pressures, seems to have disappeared. In major economies, although the unemployment rate was low before the Covid crisis, inflation and wage growth were both surprisingly weak.

If the output gap – that is the gap between actual and potential GDP – has only a very limited effect on inflation, then Milton Friedman's argument that monetary policy operates with "long and variable lags" is no longer a meaningful consideration. Ironically, given past antipathy to the idea, US economist Larry Summers' suggestion to "only raise rates when the whites of inflation's eyes are visible" (as he put it in the *Financial Times* in February 2015) is now official policy.

What the policy shift will mean in practice

In practice, how will policy be different? The Fed now aims to achieve its inflation target on average through the cycle: periods of below-target inflation will need to be offset by a phase of above-target inflation. Previously, policy aimed to bring inflation back to its target, irrespective of its recent path. Now, instead, it will explicitly look to push inflation above target after recessions and remain loose far beyond the point where, in the past, rate setters would have hit the monetary brake. The reason for this is fear of deflation. In an economy with low growth and proximity to the lower bound on interest rates, over-zealous monetary tightening is supposedly a much bigger danger than loose monetary policy.

This time it is different

The fine detail of this "average inflation targeting" strategy is little more than an academic curiosity. The key point is that US monetary policy has taken another bold step away from the *ancien régime* that dominated before the Global Financial Crisis. And where the Fed leads, others will follow.

You might say: doesn't that overstate matters? After all, central banks are still independent of the political sphere and are still legally mandated to aim for price stability. Aren't the new policy shifts nothing more than desirable tweaks to give central bankers more room for manoeuvre? Aren't they just incremental changes that are useful in a world where disinflationary forces are all-consuming, and a shift in strategy looks even more relevant thanks to Covid-19?

> *"Without the Covid crisis, the existing monetary policy-dominated regime might have limped on*

It's true that the Fed's policy review will not have an important bearing on near-term US monetary policy or, indeed, central bank behaviour elsewhere. The monetary arsenal has been all but emptied in trying to manage the Covid-induced recession. Almost all major central banks trying to protect their economies have "gone big and gone fast," as Andrew Bailey, governor of the Bank of England, recently put it.

But, looking beyond the immediate horizon, this strategic shift may prove to be a watershed moment. We are on the cusp of a major rupture in the existing policy regime, with profound geopolitical, macroeconomic and financial market consequences. This is the culmination of an incremental, but nonetheless radical, change in what monetary policy aims to achieve, how it is conducted and where it sits within the broader policy apparatus and political order.

Without the Covid crisis, which is the second calamitous economic shock in just over a decade, the existing technocrat-led, monetary policy-dominated regime might have limped on. In Covid's wake, the boundaries of the existing policy framework have expanded dramatically. Both in political and policy terms, the pandemic is transformative – much as the breakdown of the Bretton Woods system proved to be in

the late 1960s/early 1970s. Don't forget: that was quickly followed by the 1973 oil shock and stagflation.

The 1970s were largely an economic mess and central bankers were complicit in it. Monetary policy was systematically too loose in the years running up to the oil shock. That allowed inflationary pressures to build in the economic system, pressures that policymakers thought, wrongly, would be relieved by the 1970s downturn.

Even before the Covid crisis hit, there were many historical parallels with this period. They include: domestic political dysfunction that centred on how best to distribute the existing economic pie (rather than grow it); an increasingly fractured global financial structure; belief in structurally low inflation; and a powerful inflationary bias in monetary policy.

Consider how things have already changed in the light of the pandemic: ruinously expensive fiscal support; a shift towards activist fiscal policy; a growing belief across the political spectrum and in voters' minds in the power of "Big Government"; and a central banking community that sees this crisis in traditional terms as a disinflationary "aggregate demand shock". In fact, the Covid crisis appears to be much closer in character to the "supply shocks" of the 1970s.

In short, just as we have an explicit inflationary bias in monetary policy, we have a set of circumstances that are less conducive to non-inflationary, stable growth than at any time since the 1980s. In the British context, the concerns are particularly acute, given the supply-side consequences of Brexit. It's not clear how bad the shock will be, but there's broad agreement that the government's policy of a bare-bones, goods-focused free-trade agreement will hurt the UK's longer-term economic potential. Added to this, an economy that's particularly reliant on consumer service industries, as the UK's is, will be particularly exposed to the peculiarities of the Covid recession.

The undead: zombie firms and stagflation

Central bankers have convinced themselves that inflation is dead. They act on two assumptions: one, that structural trends remain disinflationary and, two, that the cyclical influence of economic activity on inflation has all but disappeared. Both have become conventional wisdom, yet both are doubtful. And they mean the monetary accelerator will remain flat to the floor for some time. That is the best way, it is argued, to safeguard price stability – because deflation is more likely than inflation.

What has fundamentally changed, and sets us on a path towards regime breakdown, is not how central banks will act in the immediate future, but their actions as the economy



gets closer to full health. The Fed is clear that its monetary accelerator pedal will be pressed to the metal until "maximum employment" is reached and inflation is above target. It sees no dangers in an inflationary overshoot.

But this sets central banks on a collision course with political reality. For the world is fundamentally different from a decade ago: the Covid recession is *not* at its core a disinflationary demand shock; and the background structural forces shaping the inflationary regime, benign through the 1990s and 2000s, are anything but today. The structural damage from the pandemic means central bankers will face rising inflationary pressures when economic normalisation is still some distance away. Even more importantly, this dilemma will emerge long before the deep political wounds of two major economic crises have healed.

The political pressure on policymakers to return Main Street to full health will be immense. The Fed's new strategy is an obvious route to relieving some of that pressure. But we have been here before and we know how this story ends…1970s-style stagflation could come back to haunt us all again. ■



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(This article reflects Ruffer's opinions at the date of publication only, and the opinions are subject to change without notice. Ruffer LLP is authorised and regulated by the Financial Conduct Authority.)

The polite way to stay secure

__Frank Stajano__ argues that online login authentication is flawed and has become too complicated. Security systems instead need to treat users with more respect

As I write, I shall pretend that the fintech-savvy readers of this column include the multimillionaire boss of the investment platform that I use for my stocks and shares ISA. But the practical advice I have for him would also benefit many others.

Every website on which customers have accounts must authenticate its users. The cheapest and most common solution is to request a username and password. In itself, this request would not be a big deal, but each user has accounts on hundreds of websites, each requesting its own complex and unguessable password, which is an unmanageable burden. Users cope with this by adopting strategies such as reusing the same password on several websites. But that allows a successful attack on a less secure website to compromise a more secure one.

The rational security engineer would recognise the futility of asking users to remember hundreds of distinct complex passwords and would steer them towards a more sustainable and secure solution. My own recommendation, besides regularly applying all available security patches to any software you use, is to use a password manager, such as the one integrated in your web browser.

The browser recognises that you are visiting a login page and, if you have an account there, offers to enter your username and password for you. You may, therefore, painlessly adopt a different complex password for every account, which protects against password reuse but also phishing. That is because the browser will not enter your password into a spoofed login page if the visited URL does not match the stored one.

The futility of friction

Your naïve security engineers, however, dear boss, are upset that these passwords, if stored in the browser's password manager, might be stolen by malware. So they introduce *additional* mechanisms to discourage the use of password managers, such as the dreaded additional password from which I must quote the second, fourth and thirteenth character.

Few password managers, if any, can jump through these extra hoops and this, your engineers think, will force your users to remember at least *this* password. It will then be safe from malware-based exfiltration and too bad for all the other websites whose passwords are still in the browser. After all, it's *your* site that's the important one and the one your engineers want to protect.

Unfortunately, this approach is flawed and will backfire on you. I did initially set up a complex extra password but the character-counting rigmarole was so annoying that I would often not use the site rather than enduring that pain. As a geek, I eventually stored the password in my Mac's keychain and wrote a script to log in automatically, but I expect a more common reaction would be to adopt an insecure, guessable password.

It's about risk, not absolutes. You will readily understand, dear boss, that security is really risk management. Mature, rational and effective security is not about protecting the system against every possible attack. Instead, it is about assessing the likelihood of each attack given the system's existing vulnerabilities, the damage that would be caused by each attack, and the cost of possible countermeasures whether preventative, before the fact, or remedial, after the fact. Then, after careful analysis, you implement those countermeasures that cost less than the damage they safeguard against.

> *"The character-counting rigmarole with a complex extra password eventually became too annoying*

Absolute security is a futile pursuit because it would have infinite cost. And when we are talking about costs, we must be inclusive. The cost of a successful attack includes not just how much money was stolen; there is also a cost in the damage to your company's reputation, reflected in your declining share price, and in the drop in new customer applications. Don't forget that the cost of a countermeasure also includes not merely how much you must pay to have it installed but also the productivity loss of those who have to jump through the hoops it introduces.

It can be easy to overlook the decline in usability that may make your system less attractive, or plainly unattractive, compared with one that is not burdened by the measures.

Would you put up with your mechanic retro-fitting a heavy-duty padlock on the door of your shiny Ferrari because it would reduce the risk of the car being stolen? There is also a moral hazard when those who impose an additional burden are not the ones who have to suffer through it.

The greatest damage caused by overzealous security countermeasures is that of making the user an enemy. The user will come to think of your engineers as annoying bullies and will, at some point, start looking for ways to circumvent your irritating security measures. It is extremely dangerous to cultivate that mindset in your customers. Once it is in place, they will abdicate any responsibility towards the security of their account, seeing it as purely your problem. It would be much wiser to take a little more risk on yourself (by accepting that the user will store the password in the browser) and to make your customers' login experience as easy and frictionless as possible. Actively enrol them as partners, with the common goal and responsibility of keeping their account secure. If you want this to be a cooperative endeavour, don't annoy them.

It's a bad idea to tax the honest people – your paying customers – to protect against misbehaviour by the dishonest people – the crooks who attack your site. As far as possible, honest people should not be made to jump through hoops unnecessarily.

A modern approach to this problem has been steadily, if stealthily, making progress over the past decade: that of considering online authentication not as a binary yes/no. Instead, it is seen as an imperfect classification problem, with a continuous range of answers between 0 per cent and 100 per cent confidence that we are dealing with the correct user. In such a framework, the login password is an important signal, but only one among many others.

Those signals may include the incoming IP address and consequent geolocation, the time of logging in as compared with the pattern of previous logins, a cookie placed on the user's machine to indicate previous logins from that same device and so on. The machine-learning-driven combination of all these inputs provides a confidence score. When the score is high, the user is logged in without any fuss. When the score is low, the user is denied access. When the score is in the middle, instead of issuing an outright rejection, additional inputs may occasionally be sought, by invoking other layers of security.

This approach has its roots in fintech, as some of the early patents relate to the back-end checks performed by credit card companies on whether to authorise payments with unusual amounts, or locations, or times, or other suspicious patterns worthy of further investigation.

But it is the large internet companies, particularly Google but also Apple, Facebook and so forth, that have taken it further. This is why, with them, you may normally access your account without even seeing a login page, thanks to a long-lived login cookie installed on your device. There may be extra hoops if you log in from a new device: you might have to respond to a confirmation email or a message on your phone or watch, or be asked to provide a one-time code from a separate authenticator application. Banks and other fintechs would do well to catch up.

> *Be firm and inflexible against unauthorised users but make authentication frictionless for genuine users*

If we were not still constrained by the Covid-19 lockdown, I would be happy, dear boss, to invite you to High Table at Trinity College, Cambridge, for a chat over a fine meal. On visiting Trinity, you would notice the beautifully manicured lawns on which nobody is allowed to walk except Fellows of the College. You would also see the polite but firm college porters, many of them former military personnel, who stop tourists who ignore the signs.

These porters have to deal with hundreds of Fellows, more than a thousand students and an even greater number of tourists. They are kind but inflexible to non-Fellows but, and this is my point, they never challenge Fellows to prove their status. To Fellows, they behave like impeccable butlers. Porters study a photo book of all Fellows, memorise faces and just silently get it right.

I have immense respect for them and I hold them up as the example of what a properly designed authentication system should do: by all means be firm and inflexible against unauthorised users, but make authentication frictionless for your genuine users, ie your paying customers. Treat them with the same respect that the porters show to the Fellows. They are your most valuable asset. ■



Frank Stajano *is professor of security and privacy at the University of Cambridge and the head of its GCHQ-endorsed Academic Centre of Excellence in Cyber Security Research. He has worked on authentication for more than 20 years. His outputs in this area include some highly cited papers, a book and a start-up*

Markets can be quite beastly

*Bulls and bears are common stock market terms, but what about meerkats and ostriches? **Dhruti Shah** discovers some strange animals lurking in the financial jargon jungle*

Most people know that a bear market is one that is falling, with a drop of 20 per cent or more over two months, and a bull market is one that is going up aggressively. But what about a bunny market? This is when there's a lot of hopping but not a lot of direction. Investment strategist Jim Paulsen first came up with the term a few years ago when he told clients: "Unlike an enthusiastic bull or a scary bear, a bunny market hops about a bit but doesn't really go anywhere." He added that bunnies had often dominated the stock market during the latter stages of past economic recoveries.

Talking about cute bunnies sounds like an ideal financial primer for children. But learning about money is not just for children. Financial illiteracy is a significant problem globally. Two out of three people around the world are unable to understand the money matters that affect their daily lives. Standard & Poor's surveyed more than 150,000 adults in 148 countries for their 2014 survey on financial literacy, one of the biggest to date. It found that few could understand basic financial concepts around numeracy, inflation, compound interest and risk diversification. There is no reason to think that the problem has gone away.

Finance confounds people for many reasons. One is the jargon. Financial markets, in particular, are a menagerie of strange beasts that have evolved over hundreds of years. Even the most domestic of these animals has a quirky history. Did you have a piggy bank as a child? The history of the humble piggy bank goes back to at least 1450. Before there were banks, people would stash their money at home in an earthenware pot called a "pygg". This explains why potters in the nineteenth century fashioned the receptacles after this farmyard animal.



The lesson is that financial concepts are often much closer to home and more intuitive than people realise. The terms used sound intimidating but they shouldn't be. What, for example, about killer bees? They're not as scary as you think. In finance, they are firms or individuals who help a company that has been targeted in a hostile takeover bid. They can include investment bankers, accountants, lawyers and tax specialists. Their defence strategies are usually to try to make a company look less appealing or profitable – and so not as attractive to potential bidders – hence the "killer" tag.

Animal metaphors are also often used to explain the behaviour of investors. A meerkat is hyper-vigilant and will keep checking his or her portfolio for the latest update. This kind of behaviour was first identified by researchers analysing Barclays Wealth and Investment Management clients over a six-year period. Ostriches, in contrast, avoid hearing news that can cause them financial discomfort. They'd rather monitor the markets when everything is riding high.

But most thinking about money starts at home. Hamsterkauf, for example, is a German word. It comes from the verb "hamstern", which harks back to the way hamsters store food in their chubby cheeks. Hamsterkauf means buying things to hoard.

There is no reason for anyone to be worried about understanding the concepts behind money and financial markets. As the past few months of the Covid pandemic have shown, the effects of a hamsterkauf are something that all of us understand as supermarkets were stripped of toilet rolls by panicked shoppers. Once we relate the strange-sounding concepts in finance to what inspired them, we can see how close to home the thinking about money really is. ■



***Dhruti Shah** is a BBC journalist, a Rotary International Peace Fellow, and the author of* Bear Markets and Beyond: a bestiary of business terms, *published by Portico. Book illustrations by Dominic Bailey*

Why it pays to take all sorts

David Turner discusses whether increasing diversity at work enhances a company's performance and looks at other benefits such a workforce can bring

Picking people for positions because they are just like you has often worked very badly. Aristocratic governments, whose members qualify for power by accident of birth, have had more than their share of the talentless. They have also often been greatly out of touch with what the governed are thinking – to the point where they are quite surprised when a revolution comes along.

If uniformity is bad for an organisation, it follows that diversity ought to be good for it. This means having a broad range of people, particularly in senior management positions. And that means no longer just heterosexual white men born into privilege calling the shots. Companies are advised to promote men and women, different ethnic groups, people who are LGBTQ+ (that is, lesbian, gay, bisexual, transgender, queer or questioning), and those born into the working and middle classes, and so on.

But does that actually make for better business?

Academics find it difficult to obtain watertight statistical proof that diversity is good for businesses, because success can have many possible causes. As Max Nathan, associate professor of applied urban science at University College London, and an expert on ethnic diversity, puts it: "It's really hard to get slam-dunk evidence on this."

> *When people with different identities sit round a table, they make more informed and better decisions*

But evidence that diversity enhances performance is gradually growing – and diversity specialists within businesses also insist that they see this in their workplaces. "When people with different identities and backgrounds sit round the table, they make more informed decisions and therefore better decisions," says Colette Comerford, head of inclusion and culture at Legal & General Investment Management.

The effect of ethnic diversity on businesses is one of the most closely studied dimensions of this. A 2020 article in the Academy of Management Journal strengthened the business case for it. "The key takeaway of this study is that organisations that have higher levels of racial diversity not only in the lower managerial level, but also the upper level, are actually the best performing companies that we observe," says Maria del Carmen Triana, of Vanderbilt University, one of the report's authors. "It's a piece of evidence that supports the business case for diversity." The paper was co-written with two other academics in the US, Orlando Richard and Mingxiang Li.

An earlier piece in the same journal, published in 2014 – 'Women on Boards and Firm Financial Performance: a meta-analysis' – found that "female board representation is positively related to accounting returns". Boards with more women tended to perform better, and boards with fewer women tended to do worse. The paper was written by two academics in the US, Corinne Post and Kris Byron.

A 2009 analysis by US sociologist Cedric Herring – 'Does Diversity Pay?' – found, more specifically, that companies with more racial or gender diversity had more sales revenue, more customers and greater profits.

Sceptics argue that this kind of research does not provide proof that diversity improves performance. Companies may be good businesses because their management is more diverse. Alternatively, they may be successful because they tend to share some other common characteristic that has nothing to do with diversity. In other words, correlation is not causation.

Some researchers have resorted to laboratory experiments to address the lack of concrete proof that diversity is beneficial. Their work sometimes suggests that "cognitive diversity" – diversity of thought – leads to better ideas and decisions, even when the diverse team is less able, judged by conventional measures, than a homogeneous team.

An example is a 2006 study of mock juries by Samuel Sommers, a psychology academic at Tufts University in the US. It found that when black people were added to the jury, white jurors processed the case facts more carefully and deliberated more effectively. "Ethnic diversity is often a good proxy for cognitive diversity," says Nathan.

Aside from better team dynamics, experts cite other reasons why diversity should help businesses.

One factor is better knowledge of one's actual and potential customers, and greater expertise in providing the products

and services they might want. Carmen Morris, managing director of Kenroi Consulting, a UK diversity specialist, notes the increasing tendency of the country's financial sector to offer products compliant with Islamic principles. Many Muslims dislike the idea of charging interest. "Some banks have an Islamic bank account because they are thinking: 'How can we increase our customer base and provide our service to Muslims?'" says Morris. "Without that understanding of laws around money, they would never have been able to develop and deliver that service."

Nathan rolls off an impressive list of possible reasons why ethnic diversity might boost corporate performance – "in theory", as he puts it, with academic circumspection. These include understanding customers better, avoiding groupthink and making use of diverse backgrounds and experiences in other ways. He also thinks it can increase companies'

> *By avoiding discrimination, a company can fish from the widest pool of talent that is available*

market access, and make it easier for them to build supply chains in home countries and home communities. Nathan does not give instances, but an example for the last item on the list might be an upmarket chain of delicatessens, eager to source the best goods from each country. An employee of Japanese origin might have a better chance of knowing which Japanese company makes the best rice cakes. They may also have a better chance of building a productive relationship with that company's owner.

Diversity may also boost performance simply because it is more meritocratic – by avoiding discrimination, one fishes from the widest pool of talent available.

Aside from gender and ethnic diversity, academics and consultancies have done less work analysing the business benefits of other types of difference, such as age, class and sexual orientation, but Comerford has thought about all these – and more. Her firm has different diversity networks, which meet to discuss their experiences. As well as the more obvious ones, such as gender and LGBT networks, the firm also has a neuro-diversity network for staff with autism, with ADHD (attention deficit hyperactivity disorder), with dyslexia and with other atypical kinds of mental make-up.

"Sitting round the table, sharing experiences, you realise that asset management is a great space to work for neuro-divergent people," says Comerford. "This is a business



where sometimes you have to sit for long periods analysing complex data, which some neuro-divergent people are particularly good at." She also deems it important to have diversity that spans the full range of character types, including extroverts and introverts.

She notes that some neuro-divergent people and introverts will not be the first to speak at meetings, but argues that this is a strength rather than a weakness – if managers know how to make the most of it. If there are 15 minutes left in a meeting, Comerford thinks the person leading the meeting will find it valuable to solicit the opinions of those who have not yet spoken. Their views may be all the more useful because people who are not the first to talk may be very good at listening, she says.

Listening may be what it's all about. Research by Brink, part of Marsh & McLennan, a US professional services firm, suggests that hiring a diverse team doesn't move the performance needle on its own. It's only when management actively listens to what it might not have thought of, or might not want to hear, that workplace diversity really delivers. ■



David Turner *is a journalist and historian. He worked as a correspondent for the* Financial Times *for many years, where he covered economics and public policy from London, and also served in the Tokyo bureau, covering investment and financial markets*

From apprentice to master

Recruitment at retail banks is changing as they hire more apprentices and fewer graduate trainees. ***Sarah Butcher*** *examines what this means for young professionals*

There are many good reasons for young people to look for a career in financial services. Banking and finance are not just essential to the UK economy, they are also some of the biggest recruiters of graduates. And they are generous payers: High Fliers Research puts average graduate starting salaries in retail banking and finance at £32,500, compared with an average of £30,000 across the UK's leading graduate employers as a whole. But the pattern of graduate recruitment in banks is changing as a new channel emerges: apprenticeships.

Some banks claim to have increased graduate recruitment in the UK in 2020, despite the pandemic. Santander, for example, ran a remote five-week induction course for 46 graduates starting in October, up from 41 in 2019. But the long-term trend is for graduate recruitment in the banking sector to fall. In the 12 years to 2020, High Fliers estimates that it declined by 14 per cent. This is likely to be compounded by the pandemic: for 2021 alone, the big four banks are predicting an 18 per cent year-on-year drop in graduate hiring, according to High Fliers' research. At the same time, degree-level apprenticeships are shifting recruitment to a different channel.

> *"Demand for technology skills is particularly strong and most banks have developed new technology pathways*

Branching out

Banks historically hired graduate trainees as a cohort of future managers to work across their business lines. Many of the early graduate programmes were general and involved "rotations" between different areas over a two-year period, at the end of which graduates could either select the area they were most suited to – or, more likely, be placed in the business areas that most needed them.

Many contemporary graduate programmes retain this pattern. HSBC's global graduate programme in retail banking and wealth management, for example, typically includes at least four rotations. These could be between customer-facing areas, products, the digital department, the leadership office and risk teams. While HSBC starts its retail and wealth graduates in its branch network, other banks including NatWest Group, avoid branch rotations entirely and focus on rotations between roles in the head office.

In the past five years, banks' graduate recruitment programmes have become more niche. Where previously there was a single "managerial" traineeship, most banks now have multiple specialist graduate pathways. NatWest is a case in point. "Our 2020 interns joined us across 14 different pathways, from software engineering, to data and analytics and change and business solutions," says Sandra Beattie, talent acquisition lead for early careers and academic partnerships at the NatWest. Lloyds is another example. It now runs six graduate programmes, covering everything from retail customers and products to software engineering and data.

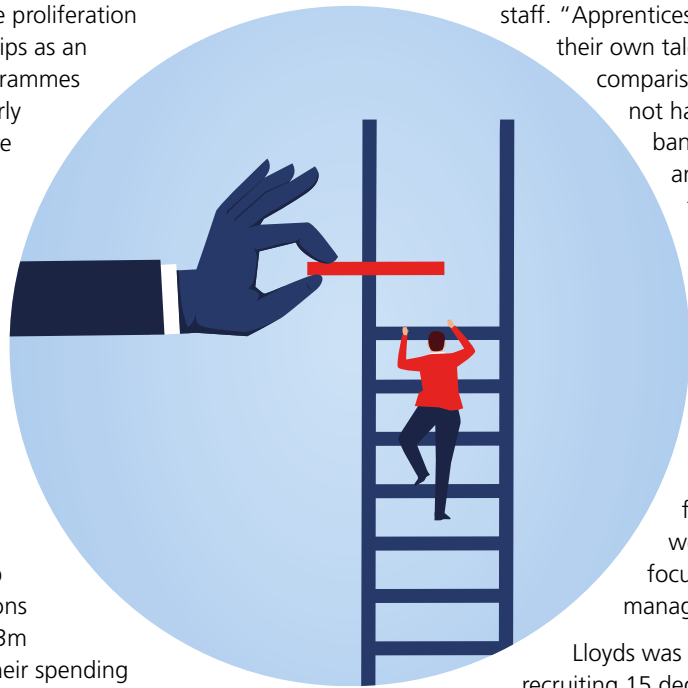
As demand for technology-focused skills is particularly strong, most banks have developed new technology pathways. At NatWest, Beattie says the software engineering graduate programme caters for its more technical roles while the change and business solutions programme supports broader skills such as change management, journey management and digital competencies. "Technology plays an indisputable role in today's society, and in our organisation we've refocused our programmes based on the skills we'll need in the future," she says.

Apprenticeships on the rise

High Fliers estimates that around a third of banks' graduate recruits in 2020 went into technology roles. But not all banks are using graduate programmes to fulfil their recruitment needs. Santander, for example, has pivoted away from graduate recruitment after discovering that graduates' digital skills were already out of date when they joined. "Over the past four years, we have begun offering more apprenticeship schemes in digital as they have proved valuable in shaping and building the specific skills we later look for in our digital hires," says Anouska Ramsay, director of culture and capability at Santander UK.

Mike Thompson, a former director of early careers at Barclays and a panel chair for legal, financial and accounting at the Institute for Apprenticeships and

Technical Education, says the proliferation of degree-level apprenticeships as an alternative to graduate programmes is the key trend in banks' early years hiring. "Most banks are aiming for 50:50 graduates and apprentices," he says, "although I'm not sure many meet that yet." Natwest may be close: according to its last annual report, it hired 205 apprentices and 226 graduates in 2019.



The appeal of apprentices is partly financial. In 2017, the UK government introduced a compulsory apprenticeship levy under which organisations with wage bills exceeding £3m contribute 0.5 per cent of their spending on personnel to a digital fund that they can only use for apprenticeship training. If funds aren't tapped within two years, they revert to the tax authorities.

Thompson says the levy has helped transform banks' approach to their junior talent pipeline. "Companies don't want to lose that money, and so they use it to hire and train apprentices." It helps too that apprentices are cheaper. "Banks are only paying degree-level apprentices salaries of £18,000 versus £30,000-plus for graduate recruits," observes Thompson.

> *"Apprenticeships let banks grow their own talent. Graduate hires might not have the skills banks want*

It's about cost and culture

There's also a cultural element to the mix. When banks hire costly graduate trainees, they are – to some extent – getting an unknown quantity. Many graduates will have attended summer internships the year before, but those internships are still only 10 weeks long (and were shorter this summer because of Covid-19). That gives banks limited time to get to know who they're hiring. By comparison, degree-level apprenticeships typically last at least three years, giving banks ample opportunity to appraise and shape their junior staff. "Apprenticeships enable banks to grow their own talent," says Thompson. "By comparison, graduate hires might not have the skills and behaviours banks want." Both culturally and financially, then, the shift to apprenticeships seems an inevitability.

As the range of available apprenticeships grows, banks are striking more of a balance between graduate recruits and apprenticeship hiring. When Level Six apprenticeships first appeared in 2015, they were limited in scope and focused primarily on relationship management.

Lloyds was one of the early adopters, recruiting 15 degree-level relationship management apprentices in commercial banking and wealth management when the programme opened. As of September 2020, Lloyds had recruited a total of 39 apprentices across both Level Four programmes and at Level Six, with more to come. This was considerably less than the 140 graduates the bank welcomed virtually in the same month, but the direction of travel is clear.

There are factors that could inhibit the growth of apprenticeships, however, and among them is Covid-19. An obvious potential problem is working from home. Apprentices benefit from in-office placements, which are normally run alongside classroom training, but it turns out that working from home is not the main disruptor. Covid-19 has made all companies reassess their priorities – with furloughing and redundancies across banks. In this hard look at staff costs, apprenticeships have not been spared.

Figures published by the Institute of Student Employers (ISE) in June 2020 indicate that graduate hiring fell 12 per cent on the previous year, whereas non-graduate (apprenticeship) hiring was down 44 per cent.

Tristram Hooley, chief research officer at the ISE, says that, because apprenticeship hiring takes place year-round instead of predominantly in the autumn as for graduates, it has been more affected by the Covid lockdowns.

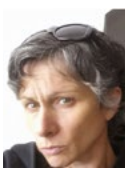
"Many apprenticeship providers have been struggling during the lockdown, which has made ramping up new

programmes more difficult," he says. " It may be that during a period of recession firms would rather recruit through the more oven-ready graduate route than recruit apprentices."

Meanwhile, apprenticeship programmes are evolving. Spurred by the "use it or lose it" need to spend the apprenticeship levy, some banks have begun developing new apprentice programmes to upskill existing staff.

The London Institute of Banking & Finance has partnered with some of the UK's largest banks to deliver degree-level apprenticeships since 2017 and it helps them use the levy to set up bespoke, accelerated programmes and develop senior leadership opportunities. The banks' aim is to "future-proof" their organisations by increasing job satisfaction and employee retention, creating a workforce that feels supported and valued by their employer.

Apprenticeships are now an accepted part of the overall recruitment toolkit, and they get to parts that other approaches might not. The Institute has, for example, been working with banks that are using the levy to attract and recruit new, high-calibre talent. These programmes give young people – some of whom might previously have found it challenging to enter the financial services industry – a viable alternative to university and access to a fast-moving, rewarding career. ■



Sarah Butcher is global editor for eFinancialCareers.. She spends her days (and many of her nights!), immersed in financial career issues and is a leading commentator on the subject, both in the UK and America

Ask Nadim

Remote but not cast adrift

Nadim Choudhury advises on how to help new recruits learn the job while working remotely and coping with an increased workload because of the pandemic

Dear Nadim,

I am the manager of an SME lending team at a big bank. As you can imagine, the past few months have been incredibly hectic in our division. We just don't have enough people to cope with all the inquiries we need to deal with. That is why I've recently recruited two new starters to help with the increased demand.

It takes time to bed in new staff, even when they are experienced but, as we are all working remotely, I'm finding it particularly difficult to integrate them into the team.

Both the starters are in support roles in account management, so they shouldn't expect to work independently. And the support and oversight should be there not just for their benefit.

That said, I know from experience that it shouldn't take this long to train someone in their roles. We're in week four of their being on board. And, although I've devoted many hours to their initial induction, I still have to do a lot of hand-holding. That's at a time when I'm working flat out on many other things.

I realise this sounds like I'm complaining, or even blaming, but I know that it wouldn't take this long to train someone new if we were back in the office where I could quickly explain, or check, things in person. We need them to get up to speed but, as things stand, they just represent additional work.

I would love to be able to work with them in the office for a time but we've been asked by the bank not to meet in person or at our regional office for the foreseeable future. I've spoken to our HR teams and they've been supportive and told me to be patient with my new colleagues but, honestly, I'm not sure what more I can do. Zoom calls and screen sharing are just not working.

Do you have any tips to help me motivate, engage, train and bring my new hires up to speed? Right now, managing them is only adding to my workload instead of making things easier.

Sally, Northampton.

Dear Sally,

Thank you for your email. I can fully understand your frustration. Trying to support your new colleagues while also leading the urgent work required of your department has to be immensely challenging. It sounds to me like you're feeling overwhelmed. That combination of heavy demands alongside a loss of control has long been recognised as the source of what can be profound problems at work, including depression and anxiety.

It's not surprising that you are annoyed that your new colleagues are not up speed with the work that's expected of them. But, as you already understand, being angry with them will not make the situation better. There are, however, several ways in which you can address the issues. Here are my top tips.

1. **Create structure and set objectives** for the week and stick to them. That will not only help you "take back control", but also enable the new hires to focus on what they need to do. That will, in turn, reduce their stress and give them a sense of agency.

2. **Make sure that your new team members have a clear outline** of when and how often they will have face time with you. This is incredibly useful as it helps them manage their own time and encourages them to prioritise key issues with you. If they know they will have your undivided attention at a particular time, they can (and should) prepare and focus.

I find that having a Monday morning catch-up helps set the tone for the week. Make sure these meetings have a clear agenda and follow it. The purpose should be to discuss the principal objectives of the week and to give team members the chance to share their success and learning from the previous week. *The Harvard Business Review* suggests asking questions such as:

- What commitments do we have this week? Who is responsible for each of these?
- How can we help each other get everything done in time?
- What areas do we need to improve this week and what could we do, or change, to achieve that?

3. **Ensure you remain calm and patient.** I know that the current situation is frustrating but please empathise with your new colleagues. Onboarding new team members virtually is incredibly difficult.

New starters need to learn many things about an organisation that have nothing to do with the technical demands of a job. For example, does the culture actually encourage asking lots of questions? Is it alright for people to get things wrong? Those things are learnt through daily, personal contact. Without a lot of contact and communication to fill the gap that develops over Zoom calls, new staff can feel uncomfortable about trying to find out the things they need to know – even when those things *are* simple facts about the job in hand.

> *"There is no such thing as over-communication, especially for people starting a job. The new staff will need to understand what you want and to trust you*

4. **Over-communicate** – you're doing the right thing. While it may seem like you are hand-holding, that is what is needed to ensure the new hires will feel "safe" on the team. There is no such thing as over-communication here, especially in the first few months of a new role. The new staff need to be able to understand what you want and to trust you, in the absence of all the personal cues that people have in the office. And you need to trust that it will get better.

You obviously believe that your colleagues are competent otherwise you wouldn't have hired them. Find out what communication channels work for them and then adapt your style accordingly. You should also be clear about what works for you. For example, do you favour a top-down or bottom-up approach to communication?

5. **Ask for support from other team members** – it shouldn't all fall on your shoulders to train the new staff. Is there a peer who you can ask to support you, especially with the broader training that is required, for example on systems, culture or processes?

This may relieve some of the pressure that you're feeling. It should also make the new staff feel more included.

The more people they 'meet', the more they should be able to understand the firm and feel part of what it does. You should also ask HR if they have developed any online materials to help with inductions.

6. **Find out what your team members need from you**. Take some time to do 'non-work' activities with them.

Again, ask HR if they have organised any online activities to replace face-to-face socialising.

What are your team's values and work behaviours? What

values and behaviours do you want to encourage? The more you understand their needs, the better you will be at supporting their learning path.

7. **Make sure that the new recruits have access to all the technology they need**, passwords, databases, access rights – this is usually an issue that many new recruits face when starting remotely. But keeping that frictionless should be managed by the IT department, not by you.

I hope this helps.

Nadim. ■



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Dancing to different tunes

Deborah Sabalot *explains why failure to keep UK financial regulation equivalent with that of the EU post-Brexit could cause uncertainty, if not financial instability*

As if Covid-19 wasn't enough, the UK government has to go looking for trouble by announcing its plans to renege on some inconvenient parts of the Withdrawal Agreement with the EU.

This news will raise more issues about the future of UK financial services in a no-deal, World Trade Organization (WTO)-based world. If equivalence decisions between the EU and the UK cannot, or will not, be made before the end of the year, things get complicated. Arguably the UK is not as reliant on the financial business it does with the EU as the EU is with the UK, but the whole system does rely on a high degree of regulatory certainty.

Best-laid plans

Originally, the UK's plan was to have equivalence decisions in place for the major pieces of EU legislation by June 2020. That deadline, like so many others in this process, has come and gone. Covid and general foot-dragging on both sides

> *Being subject to EU laws has not been acceptable to the UK government from day one of the Brexit process*

has meant the EU has failed to put in place the mechanism for deciding what UK financial regulations will be equivalent post-Brexit. Unless something changes fast, that could mean UK firms having to comply with each EU member state's national rules once the transition period ends, which would be much more complex.

So whose fault is it that the UK and the EU are in this quandary? When the UK parliament returned on 2 September, Andrew Bailey, governor of the Bank of England, testified before the Treasury Select Committee on Brexit readiness. He said that the UK had submitted everything originally asked for as part of the equivalence process, but there were some follow-up questions that were still open. He also reported that equivalence might not be all that the MPs were expecting. It appears that article 47 of the Markets in Financial Instruments Regulation, which relates to investment banking services, has been "taken out" of the equivalence process for the moment by the EU because of impending changes in its own rules in the light of the pandemic.

Rule-taking, not rule-making

That is a problem. As Bailey said: "I just do not see how we can have an equivalence process where the EU essentially says, 'We're not even going to judge equivalence at the moment, because our rules are going to change.' What does that mean? It means that they think this is a rule-taking process, whereby they will change their rules, ring us up to tell us what they are, and then say, 'Of course, if you want to be equivalent, you had better adopt the changes to the rules that we have made.'"

Alex Brazier, executive director for financial stability at the Bank of England, told the Treasury Select Committee that: "The danger of a textual equivalence regime is that you cannot necessarily keep up with a changing system and keep the rules well tailored to that system… and in that sense it is a risk to stability. The flipside is that not much business in London and the UK's financial centre actually depends on equivalence. There is about £300bn-worth of revenue. About £30bn of that comes from EU clients. Less than a third of that is at play when it comes to equivalence, so there are trade-offs here between business going on and the financial stability risks. I think it is pretty stark."

This approach reopens the whole question of the UK being a rule-taker. Being subject to EU laws hasn't been acceptable to the current government from day one of the Brexit process. But getting the right balance between equivalence and sovereignty has been difficult. History has shown that equivalence decisions can be made quickly – or they can take several years, particularly where they form part of wider trade negotiations. They can also be quickly overturned, as in the case of the US-EU data protection privacy shield. That was spectacularly sunk by the European Court of Justice at a stroke in the summer.

WTO rules are no nirvana

Trading under WTO rules is no nirvana, however. The WTO, established in 1995, is fundamentally a negotiating forum. Its agreements, negotiated and signed by the 164 member nations, provide the legal ground rules for

international commerce. There are three main areas of trade that are covered by the rules: the General Agreement on Tariffs and Trade (GATT), which governs trade in goods; the General Agreement on Trade in Services (GATS); and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). GATS provides for four methods of supply of services: cross-border supply, consumption abroad, commercial presence and presence/movement of natural persons.

Under the WTO agreements, countries cannot normally discriminate between their trading partners. Obligations with regard to trading in services can be separated into two categories: general obligations that apply directly and automatically to all member countries, regardless of sector; and conditional obligations that apply to sectors where the WTO member country has taken on market access and national treatment obligations.

Granting more favourable access to one member requires that country to extend the same treatment to all other WTO members. This principle is known as most-favoured-nation treatment and is the backbone of the WTO rules. Another fundamental general obligation is transparency. Under that, member states must publish all measures of general application relevant to the WTO's functions. They must also set up national enquiry points to respond to other members' information requests. The WTO also has a dispute resolution mechanism, but this has been hampered by the US pulling out of the Appellate Body of the organisation earlier in 2020.

> *"The UK will have to move away from the current arrangement whereby the EU negotiates on its behalf*

In 1997, 70 WTO members concluded a financial services agreement (the Financial Services Annex) covering more than 95 per cent of trade in banking, insurance, securities and financial information. The organisation's work programme, the Doha Development Agenda, added negotiations and other work on WTO rules such as investment, competition policy, trade facilitation, transparency in government procurement and intellectual property. But progress on the agenda has been stalled since 2017 because of the US administration's dislike of global agreements. The Trump administration has called for a "fresh start".



Although the UK is a member of the WTO, it will need to make the transition from the current arrangements, whereby the EU negotiates commitments on its behalf (for the whole of the EU as a bloc), to a position where it has its own separate, UK-specific commitments. This means it will need to structure its own schedule of WTO commitments in agreement with all other members. That's potentially time consuming and, given the current political tensions in trade and services, not entirely straightforward. In addition, few countries actually operate only under GATS rules. They usually rely on a framework of other regional and bilateral agreements, but these take time and effort to put in place.

So will the EU hurt itself more than it hurts the UK by not moving on equivalence? It has made equivalence decisions in relation to a number of jurisdictions. Those for Canada, Japan and Switzerland stand out. Bailey says he is "still a strong supporter of equivalence, because it means that we have open markets that are well regulated and that people can do business where they want to do business. That will be better all round." But it takes two to tango, which means that both the UK and the EU will need to get in the mood to dance. ■



Deborah Sabalot *is a consulting lawyer who advises financial sector clients on UK and international regulatory and compliance issues*

Now's the time for a BritCoin

***David Birch** makes the case for a UK central bank digital currency, saying it would aid growth and efficiency and also boost Britain's image in the world*

A year is a long time in the world of digital currency. This time last year Mark Carney, the then governor of the Bank of England, started talking about synthetic hegemonic currencies (or SHCs), signalling that the topic of digital currencies was acceptable in polite society and no longer the sole province of bitcoin evangelists or private money obsessives (eg me). If you're wondering what an SHC is, it's a currency that is made up from a basket of fiat currencies. Examples are the Special Drawing Rights of the International Monetary Fund and Facebook's proposed Libra currency, which was the proximate cause of Carney's considerations.

Whether they are synthetic and hegemonic or just plain electronic and fiat, digital currencies are now of interest to central bankers around the world. And that interest in central bank digital currencies (CBDCs) is growing. In spring 2020, the People's Bank of China kindly kick-started the marketing campaign for my new book, The Currency Cold War, by piloting the digital renminbi in four cities. Now the current Bank of England governor, Andrew Bailey, is musing out loud on CBDCs. (There are more details in his 3 September, 2020 speech to the Brookings Institution, 'Reinventing the Wheel'.) He wondered whether it might be good for society if central banks were themselves to harness electronic payments innovations and digitise fiat currency. Importantly, he also said that what he referred to as "stablecoins" and CBDCs "are not necessarily mutually exclusive".

I've put quotes around "stablecoins" because I don't think either a basket of currencies or a currency board is a stablecoin. The term "stablecoin" should be reserved for cryptocurrencies whose value is algorithmically controlled

> *A sound central bank digital currency could permanently raise GDP, says the Bank of England*

to balance supply and demand. (There is more on the confusions around this in the European Central Bank's Occasional Paper 247, 'Stablecoins'.)

Stablecoins or not, why would the Bank of England want to issue a digital currency? I can think of at least three good reasons: growth, efficiency and soft power.



Economic growth

The Bank of England Staff Working Paper 605 on 'The Macroeconomics of Central Bank-issued Digital Currencies' says that a sound CBDC could permanently raise GDP. In the example it uses, the Bank of England puts this boost at around 3 per cent. The fillip would come from reductions in real interest rates, from a fall in distortionary taxes and from lower monetary transaction costs. The Bank of England also notes that a CBDC would provide an additional monetary policy instrument that could substantially improve its ability to stabilise the business cycle.

GDP growth aside, there is another excellent reason for taking this step, which is that cash has no application programming interface (API). APIs are used to link two software platforms so that they can exchange selected data. Notes and coins clearly can't do this. But we're currently transitioning from "dumb money" to "smart money", ie programmable money, as Simon Scorer from the digital currencies division of the Bank of England pointed out on a Bank Underground blog. Scorer made some interesting points about the need for some form of digital fiat currency and how digital fiat could become a platform for innovation – something I strongly agree with.

The potential innovations he mentioned included making money programmable so that, as an example, it might be possible to automate some tax payments. Imagine if, when buying a coffee, the net amount could be paid directly to the coffee shop, with a 20 per cent VAT payment routed directly to the tax department. Or perhaps parents may be able to set limits on their children's spending or restrict them to trusted retailers.

Economic efficiency

Retail CBDCs seem to be more advanced in areas with high innovation capacity and where the informal economy is larger. (See the August 2020 BIS paper Working Paper 880 'Rise of the Central Bank Digital Currencies: drivers, approaches and technologies' for more details.) The paper argues that, the bigger the tax gap, the more interested central banks are in digital currencies. Digital CBCD use might come down to authorities wanting a data trail for transactions. In his speech, Bailey says that "the data generated could have huge opportunities for the detection and prevention of financial crime, but this must be balanced with the risk of surveillance into private financial matters". Given how far that surveillance could go, this is an important topic that deserves mature and informed debate.

External influence

Although it's less tangible than growth or efficiency, soft power is, I think, just as important. That makes digital sterling the perfect post-Brexit project. It's an expression of faith in the white heat of new technology that is emblematic of our newly independent nation and a mechanism for projecting British soft power into the world. That is not sarcasm, by the way. The Old Lady of Threadneedle Street should announce that, in response to a recently published National Audit Office report on the production and distribution of cash, which notes that the government has no strategy for the transition to cashlessness, a digital pound is coming.

> *"The BritCoin would be distributed to the public by commercial banks but stay under central bank control*

The UK way

If digital money is desirable, how should it work? In the 1990s, the model that was chosen for the Mondex experiment in "electronic cash" in the UK was to have the central bank control the creation of the digital currency, but to have it distributed by commercial banks through their existing channels. This is what is known as the "two-tier" implementation. You wouldn't use smart cards for a digital currency today, however; you would implement it using mobile phones, a kind of BritDex.

A cheaper alternative is to have the central bank create accounts for all citizens, businesses and other organisations. You could imagine something like M-Pesa, the mobile phone-based money transfer service, but on population scale, BritPesa if you like, in the UK example. This will be cheaper because it will be completely centralised. The marginal cost of transferring value from the control of one person or organisation to another through such a system would be negligible. Central banks do not really want to implement such a "one tier" solution, however, because it would mean having to manage millions of accounts. They would prefer somebody else to do this and to deal with everything else that goes with interacting with the public.

Commercial banks and many other non-bank players (think Alipay in China, for example) already have the apps, the infrastructure and the innovative approach to deal with the public. Using them to deliver a CBDC would not only bring the digital currency to the mass market but it would also

open up the potential for the digital currency as a platform for innovation and development.

Alternatively, there could be something like USDC, which is the "stablecoin" of Circle, a peer-to-peer payments technology company. It is backed by a 100 per cent dollar reserve implemented on top of a cryptocurrency platform. This kind of digital, token-based solution is what the European Central Bank's Yves Mersch spoke about at the Consensus conference in March 2020. Such a BritCoin would still be a two-tier solution that is distributed to the public by commercial banks but it would remain under the central bank's control.

Brexit bounce

The Bank of England's discussion paper on CBDC talks about a "platform approach" and emphasises again the innovation bonus that might result. How could it work? Imagine a merging of something such as India's Unified Payments Interface, Kenya's M-Pesa, social media and the "lifestyle apps" coming from the Far East. Then you can begin to develop a picture of just how powerful such an implementation might be in all markets.

In the Bank of England's model, it is assumed that the central bank runs the platform and that payment interface providers, such as banks, have access to the platform to provide services to users. The Bank of England does not envisage this platform as a cryptocurrency platform but says that the technologies of shared ledgers might be the best way to implement it. Shared ledgers are blockchain, which finds its way into many headlines. But these comments again suggest to me that it's not the shared ledger, which will be the backbone, but the "programmable money" applications that will bring radical innovation in new digital currencies. This is why I think BritCoin is the most interesting of the three options set out above and the best choice for a money moonshot.



I agree with Martin Walker, director of banking and finance at the Centre for Evidence-Based Management, who wrote in LSE Business Review that it is not clear whether smart money demands shared ledgers, consensus applications or tokenisation. But now is the time for some new thinking.

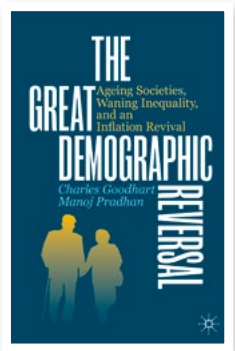
I hope the Bank of England decides to take a global lead in the race to create smart money for the digital future, rather than continue with digitised versions of money from the analogue past.

A Brexit Bounce could be just the narrative we need to re-energise British invisibles in the new online world. ■



David G W Birch *is a director of the secure electronic transactions consultancy, Consult Hyperion, and a visiting lecturer at the University of Surrey. He is an internationally recognised thought leader in digital identity and digital money, one of Wired magazine's top 15 global sources of business information, and a CSFI research fellow*

Enter the ageing dragon



TITLE
The Great Demographic Reversal

AUTHOR
Charles Goodhart & Manoj Pradhan

PUBLISHER
Palgrave Macmillan (£22.99)

The sub-title of this book is provocative: "aging societies, waning inequality and an inflation revival." Most of us would agree that our societies are ageing. But is there any prospect of inequality receding in our countries, or of inflation coming back to life?

Well, Goodhart and Pradhan think so. They are interested in the big picture, in global trends measured in decades. They think the world economy is at an inflexion point and that the major driver of this shift will be changes in China.

They argue that, as China emerged on the world stage, the increase of 240m in the working-age population provided by that country was enough to undermine the bargaining power of labour almost everywhere and to keep inflation in check. But, as the globalisation of supply chains held down labour costs across the industrial world, it also lifted incomes across emerging market economies. So, looked at globally, inequality has decreased even as income shifted away from labour and towards capital across the advanced economies. On top of this, China generated a savings surplus on such a scale that it moved real interest rates worldwide to levels well below their historical average.

Why is this about to change? Well, the most important factor is that China will not be adding workers to the world labour supply going forward. Its population is ageing. One-child policies are limiting its workforce growth and the migration from rural to urban areas within China is played out.

Moreover, the ageing of the populations of the advanced economies will only exacerbate labour shortages there, so that the bargaining power of labour will rise once again like a phoenix from the ashes and inflation will reappear in industrial countries.

There are many reasons why Goodhart and Pradhan might be wrong and the book examines these systematically. India and Africa might take over China's role over the next three decades as the world source for cheap labour. That is except for the suffocating effect of chronically poor public administration and, in the case of Africa, low labour mobility.

Technology might augment labour so that productivity would grow fast enough to accommodate non-inflationary real wage increases in the industrial world. That is except that much economic activity is now in services that are intrinsically difficult to automate, including caring for the elderly.

Migration from the poor countries to the advanced economies might keep wage pressures in check. But migration on a sufficient scale is increasingly a political impossibility. Retirement ages may rise, effectively

> *Goodhart and Pradhan dispose of the counter-arguments to their thesis one by one*

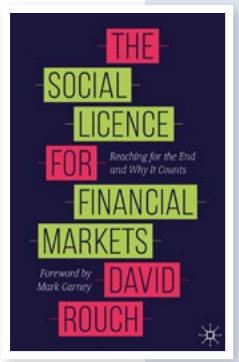
supplementing the labour supply and mitigating the increase in national incomes devoted to looking after the elderly. The authors argue that these effects will be relatively small. And so on; they dispose of the counter-arguments to their thesis one by one.

They believe that we are in a worldwide debt trap. Public and private sector debt was rising even before the pandemic took hold and now it has reached historic levels. As inflation rises going forward, real interest rates will rise and debt servicing burdens will shoot up, creating severe pressures on both the private and public sectors. They do not see any great acceleration in growth rates. Solid evidence of AI or other technology unleashing extraordinary increases in productivity is not there. So, a period of painful adjustment lies ahead.

Whether you agree or not with their prognosis, it is a pleasure to read a book this well argued. There is a good deal of careful analysis and there are lots of tables and graphs. (And, after all, what is the use of a book without pictures or conversations, as Lewis Carroll's Alice pointed out.)

Stated moderately, the thesis as a whole adds up: over the next three decades there is a good chance that economic growth will be weak and adjustments will be difficult. Inequality may indeed decline in the advanced economies (as it continues to do so globally) and inflation may pick up as populations age with all the attendant consequences. ■

Charles Taylor *– economist and former deputy comptroller for capital and regulatory policy in the US*



TITLE
The Social Licence for Financial Markets

AUTHOR
David Rouch

PUBLISHER
Palgrave Macmillan (£24.99)

As a financial and regulatory lawyer, David Rouch is well placed to analyse and address the problems facing the modern financial system, in particular the disconnect between its goals and purpose and those of the society it was built to serve.

Despite his legal training, Rouch has written an engaging book, which is a far cry from the dry legal tomes of his profession. He works hard to avoid the jargon and complexity of his subject matter and produces a detailed critique of the legal and regulatory framework that governs our financial system. Rouch draws on personal experience, philosophy and psychology to develop a narrative of how we got here and an approach for where we go from here. It is easily accessible to anyone who cares about the role of money and finance in society.

The title of the book is taken from a speech made by Mark Carney when governor of the Bank of England. It proposed that we need to start from the "social licence" for financial markets if we are to address the problems that came to a head in 2008 and beyond. Such a licence would not aim to provide a safe space for the pursuit of money and profit, but rather to embed purpose and values from society into the culture and practice of finance.

Rouch builds an argument that shows the limitations of approaches based on rules and regulations. The alternative he proposes is to foster a culture of finance that pursues "just means to just ends". He provides a detailed exposition of how shaping policy around the social licence for financial markets would ensure, in turn, the preservation of social capital. That social capital allows markets to operate on a more positive set of principles, in particular positive reciprocity and broad-based mutuality.

Some might view this approach as overly optimistic given the cadence of financial scandals and crashes over the last 30 years. However, Rouch makes a strong case for his belief that rules-based legal and regulatory frameworks are not really what underpin

> *"What enable financial transactions, he says, are social trust and social capital*

the markets. What enable financial transactions, he says, are social trust and social capital. It is perhaps surprising to hear this assertion from a financial lawyer, but Rouch goes further. He argues that a lack of trust in the motives of individuals, and a reliance on rules, plays a major part in the abstraction of finance from the mores of society. He believes that the rules are also often a barrier to greater action by the financial system on just aims such as sustainability.

Rouch makes efforts to ensure the overall thrust of his argument can be easily consumed via useful speed read and summary sections. That gives the reader space to ponder his detailed and extensive research. I found myself reading forwards and back to consume first the argument and then the evidence, before turning to the section on practical action.

The only criticism would be the relatively limited exploration of the meaning of money itself. Rouch's critique assumes money to be objective and asocial in contrast to alternative forms of value exchange such as a gift. (It should be noted that he doesn't view the practice of finance itself as objective and asocial.) Such analysis would strengthen his argument for greater porosity between the financial and the social, between value and values. If you accept that money

is constructed by society then it follows that finance should conform to the rules and norms of society and not create an alternative social system based solely on self-interest.

The social licence for financial markets requires a policy approach that is ambitious in its scope and radical in its design. But the direction of travel for regulation, especially in the UK as one of the global financial hubs, is for more rules not stronger principles. Rouch is clear that finance does have the potential to make a positive contribution to society and should not be seen solely as something to be controlled because it regularly causes damage This book is an important contribution to that debate that deserves to be widely read. ■

Bruce Davis *– founder of Abundance Investments*



TITLE
Better Business: how the B Corp movement is remaking capitalism

AUTHOR
Christopher Marquis

PUBLISHER
Yale University Press (£21.85)

The preface to this book starts with the line: "The B Corps movement is the most important social movement you've never heard of." Well, I had heard of it and was mildly positively disposed towards this brand of company, which is driven by B for "benefit" to stakeholders, as in the triple bottom line: people, planet, profits.

For those who want a history of this interesting and well-intentioned movement, which dates back to 2006, and to read heart-warming stories about companies that do well by doing good, this is the book for you. But that amounts to preaching to the converted.

The author, Christopher Marquis, a professor of global sustainable enterprise and management at Cornell University, is on a mission. So strong is the tone of his advocacy that a cynic might wonder whether the book had been commissioned by the B Corp leadership. In this age of endless debate about stakeholder capitalism and the need for corporate purpose other than making money, his argument ought to fall on fertile ground. But for those who don't think the current capitalist system is beyond redemption, his approach will be too polemical. It relies on setting up "shareholder primacy" as a "cancer" that must become "a thing of the past". It becomes a bogeyman blamed for every evil from environmental depredations to abuse of the labour force and for things that plainly are not true, such as the destruction of American competitiveness.

The author's view is tempered: "properly regulated by governments, capitalism can be a tremendous force for good". Isn't that what we have now? And further progress, according to the taste of voters and other "stakeholders", can and is being made in the same way.

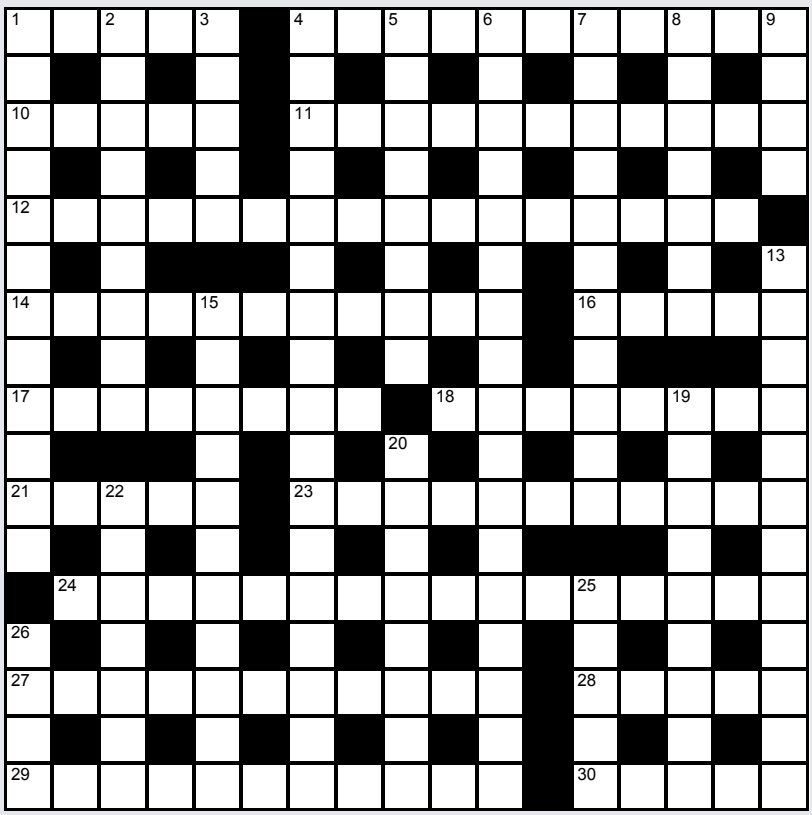
Polemics aside, what is a B Corp? A company required by law to consider the interests of employees, customers, communities and the environment, as well as shareholders. This is a worthy corporate form, but it is a misapprehension to assert that directors of conventional enterprises must only serve shareholders. Marquis acknowledges that in 31 US states, before the B Corp movement, directors had discretion to consider non-financial stakeholders. In the UK, the Companies Act requires directors to have regard to the above list and their duty is actually to the company as stewards of its assets, not explicitly to shareholders.

In any case, a company cannot succeed for any length of time if it annoys its customers, antagonises its staff and ruins the environment. Even Milton Friedman (predictably, a villain in this story) said that an executive should seek to make money for shareholders "while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom".

Some companies will want to have the bespoke constitution that the B Corp movement promotes but it is by no means essential. Regular capitalists can be enlightened enough to see where the risks and opportunities lie when priorities change – as they have done throughout history. ■

Jane Fuller *– co-director of the CSFI*

The FW crossword No. 80, set by Falcon



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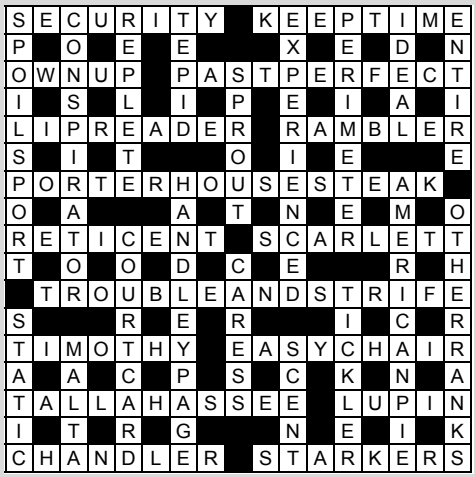
ACROSS

1 Very good, an old musical instrument (5)
4 Use dress with rip (4,3,4)
10 Silly how picture ends? (5)
11 Reptile unnerves nude endlessly (11)
12 One giving evidence – architect answers uncomfortably (9,7)
14 Convalescent abroad meeting an expert no longer in the game (3,3,5)
16 Senior joiner losing weight (5)
17 Fish farm machine (8)
18 Play safe by backing down (5,3)
21 Proportion of allowance reduced (5)
23 Thickness of cynic's notes, possibly (11)
24 Athletic contest: contemporary collapsed on tenth lap (6,10)
27 Extremely significant, our game in West Midlands town (11)
28 Saw a daughter decline (5)
29 Most agitated concerning wife given unpleasant time (11)
30 Pleasant hugging European relative (5)

DOWN

1 Perfect irony shocked Pericles (6,2,4)
2 White stone in altar base cracked (9)
3 Ring huge Greek character (5)
4 Best action to be taken over plot summary? Nothing could be as bad! (5-4,8)
5 A northern cafe, not a place for waiters! (8)
6 Detrimental factor of theft minion neatly disguised (1,3,2,3,8)
7 Policemen return showing impartiality (11)
8 Passed – pleased, for a change (7)
9 A tall grass ruminants rejected (4)
13 One may be attached to a younger relative's property? (6,6)
15 "Rose and Crown" almost involved in game without goals (2-5,4)
19 Criticise the Spanish willing to produce quiz show (5,4)
20 Outsider grounded, in need of treatment (8)
22 Couple in book holding pig up (7)
25 School exercise (5)
26 Czechoslovakia's capital? (4)

Solution to FW crossword No. 79 set by Falcon



Across: 1 Security, 5 Keep time, 10 Own up, 11 Past perfect, 13 Lip-reader, 14 Rambler, 15 Porterhouse steak, 19 Reticent, 21 Scarlett, 23 Trouble and strife, 26 Timothy, 28 Easy chair, 30 Tallahassee, 31 Lupin, 32 Chandler, 33 Starkers.

Down: 1 Spoilsport, 2 Conspirator, 3 Replete, 4 Tepid, 6 Experienced, 7 Perimeter, 8 Ideal, 9 Entire, 12 Sprout, 16 Handley Page, 17 American Pie, 18 Other ranks, 20 Court card, 22 Caress, 24 Tickler, 25 Static, 27 Malta, 29 Scent.

Congratulations go to Jenny Byram of Bristol, the winner of the August crossword

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