Financial Services

Joe

Welcome to the ACCA, Association of Chartered Certified Accountants podcasts on commercial In this session we are going to use the tools discussed in the introductory episode and apply them to Financial sector.

Clare

In this session we'll be focussing on how the financial markets operate before looking at individual firms within the financial services sector, and how you can focus on their mission statement, core values, key drivers, finance and risk profile to develop your own commercial awareness.

The financial services sector is made up of several stakeholder groups all working together: individuals, companies, banks, institutional investors and brokers. You could work in retail banking, investment banking, at an insurance company or at one of the blue chip organisations.

Companies and individuals go to the financial market to look for funds, and advice on the best way to use these funds. They will usually approach a bank. Now there are three types of banks within this sector: retail, investment and integrated, and we will explore the differences between them a little later.

Retail banks are the ones that you and I most commonly deal with. Their business priority is to take deposits and to lend out money. They also borrow and lend money from each other on the London Interbank market. LIBOR is the London Interbank Offered Rate – this is the interest rate at which banks lend and borrow.

Following the collapse of some financial institutions during 2008, the banks leant to each other at a higher rate, due to a lack of confidence.

You have probably heard LIBOR in the news, for example the Barclay's libel case, which ultimately led to the resignation of Bob Diamond.

Joe

Now, let's look at investment banks, which traditionally had two key functions. The first was to underwrite and distribute bond and share issues. The second was to buy and sell bonds and shares once they had been issued. Nowadays they do this and a lot more. In the UK many of the investment banks used to be known as Merchant Banks before they were incorporated into the international investment banks. Historically, they would advise companies on their finance strategy and how to raise funds, but this activity is now known as Corporate Finance, which is one part of an investment bank's function.

Integrated banks are a combination of the two. Some examples of these types of banks include JP Morgan and HSBC.

So if you're preparing for an interview at a bank, what are the things that you should focus on?

There are two ways in which you can make sense of banks. The first is to look at their core activity. HSBC for example, is famous for operating globally. The second is to look at the history of the bank, for example Santander in the UK is made up of the acquisitions of Abbey in 2004 and Bradford & Bingley and Alliance & Leicester in 2008, and now its culture is essentially Spanish.

Working in an accountancy role within a bank you also need to be aware of up to date regulations. At the moment, this includes Basel 3, which is a form of regulatory risk management issued by the Basel Committee on Banking Supervision. The purpose of this regulation is to create an international standard of regulation about how much capital a bank needs to put aside to guard against the types of financial and operational risks they face.

Clare

Now, let's take a brief look at institutional investors…

There are four types of institutional investors: insurance companies, pension funds, fund managers and sovereign wealth funds. You and I provide the former institutions money to invest through payments for insurance, pensions and savings. In the finance markets these investors play a huge role. They buy the bulk of bonds and shares that are issued. They have the power to decide the outcome of a takeover deal by accepting the bidders offer to buy their shares. They also invest a lot of money into private equity.

And the final group are the brokers. The most common and recognised term for a broker is a stockbroker. In today's environment you now have brokers who act as agents, dealers who trade and make markets, and broker-dealers who do both.

This of course can lead to an increased risk of a conflict of interest. It's known as insider trading and is illegal. It's very difficult to prove but the reputational damage can be huge. As a measure against this banks create a wall between the two departments so that they don't share information.

An example of this conflict of interest is a high profile case from December 2012, the Facebook IPO disclosure. According to the Massachusetts securities regulator, there was a conflict of interest when a senior banker at Morgan Stanley coached a Facebook official on what to say to analysts. Morgan Stanley was fined £3 million by the Massachusetts securities regulator for 'improperly influencing' analysts before Facebook's share sale.

This is why ethics are so important in business, and why ACCA includes the Professional Ethics module in the ACCA Qualification. Let's take a look at one of the organisations operating in this sector and what their mission and values tells you.

Joe

JP Morgan is a global financial services firm with clients based in over 100 countries. They've been around for over 200 years and their mission statement is "*first class business in a first class way.*" What does this mean?

It's a straightforward statement. Finance is their business, and their product is services relating to finance. If you look at their website you can see the different financial services that they offer. There are the investment and commercial banking elements as well as other financial activities such as asset management, private banking, securities service and treasury service.

But, have they delivered on their mission statement?

JP Morgan, in their 2011 communications to stakeholders, reported an increase in earnings, and the firm raised capital and provided credit of over $1.8 trillion for their commercial and consumer clients. They also bought back $9 billion of stock, and opened offices in several new locations. By the end of 2011, they had more than 250 bankers in 35 countries, and they plan to have 320 bankers in 40 countries by the end of 2013. Also, they gained a 73 per cent rise in their trade finance loans in 2011, totalling $37 billion. These results demonstrate that JP Morgan not only remain a first class business, they also take their obligation to shareholders seriously.

Joe

And what about their values? JP Morgan are committed to serving their customers and positively impacting the lives of millions of people and their communities. In their 2011 communications to stakeholders, JP Morgan demonstrated their commitment to these by reporting that they provided more than $17 billion of credit to small businesses, up 52 per cent from 2010. They also raised capital or provided credit for more than 1,200 not-for-profit and government entities, including hospitals and universities.

Now, let's looks at the BCG Matrix. The matrix is a simple tool to assess a company's position in terms of its product range – you can find out more about it in the first podcast of this series.

In the context of Financial Services it can be difficult to apply this matrix if you don't have an in-depth knowledge about the different products on the market.

In the first nine months of 2012, worldwide revenues from investment banking were 44.9 billion dollars, but this was 19 per cent down on the same period from 2011. The most lucrative product was mergers and acquisitions, but revenues from this also dropped by 18 per cent, and revenues from equity-market earnings fell by 29 per cent.

In retail banking, you could put internet banking into the ‘cash cow’ box because it’s a business unit that brings in a regular flow of income without using up a lot of resource. Traditional cheque books are being phased out by 2018, and rely on a lot of resource to process (so could be classed as a failing product). Countries can also fall into this matrix. China and India could be seen as rising stars as they are the countries to invest in.

You should bear in mind that a company’s matrix is subject to change due to the macro environment. All businesses are at risk from the changing outside environment and so they will to some extent try to mitigate these risks where possible.

Assessment of risk both internally and externally is vital in the financial services market. Failure or perceived failure to manage risk is highlighted as one of the causes of the initial credit crunch.

Joe

So how did the crisis happen?
There are lots of reasons why, but from a risk management and corporate governance perspective the heart of the problem includes:

- Institutions failing to appreciate and manage the connection between the inherent business risks and bonus incentives
- Bonuses that encouraged excessive short-termism.
- Risk management departments in banks that lacked influence or power
- Weaknesses in reporting on risk and financial transactions
- Questions over the corporate governance measures in place
- The adequacy of regulations. So principle based regulations as opposed to rule based regulations.

The real estate industry was one cause of this crisis. Mortgages were given for a higher value than the homeowners could afford, leading to many people defaulting on their repayments.

All of these factors played a role; they are complex and interrelated.

The financial crisis can be viewed as a failure in corporate governance and risk management. Previous financial episodes such as the savings and loans bank crisis in the US in the late 1980s, the East Asian crisis in the late 1990s and, of course, the failure of Enron and WorldCom, also involved elements of inadequate risk management.

If you want to find out more about risk management, you can visit the ACCA graduate website and read relevant articles.

Clare

This brings us to the end of the ACCA commercial awareness podcast on the financial services sector. Thanks for listening. For more information about ACCA and to find the other podcasts in this series, go to www.accaglobal.com/ukgraduates.

Goodbye

Supporting documents:

- Terminology Guide
- How to read an Annual Report
- How to read the Financial Pages
- Toxic Assets article
- Corporate Governance and the Credit Crunch