A Chairman and CEO Survey:

What do Financial Services Chairmen and CEOs want to see happen to keep the City strong?

A report by the Board Practice of Per Ardua Associates Limited

For Chairmen and CEOs in Financial Services | JUNE 2016

PER ARDUA ASSOCIATES LTD
EXECUTIVE SEARCH

FOREWORD

2016 is a pivotal year for Financial Services and the City of London. It is a year in which the future of the country's relationship with continental Europe will be determined for a generation. Shortly after you receive this report, we will know what sort of future this will be. It is also a year in which banks, insurers and asset managers tackle the implementation of several major pieces of regulation, involving – in many cases – a significant overhaul of their businesses.

Indeed, having spoken to 35 Chairman and CEOs of the major banking, asset management and insurance institutions in the City, it is clear that, aside from the referendum, regulation also dominates their thoughts.

The fact that regulatory tailwinds are a major worry may come as something of a surprise to people, given variously the Chinese slowdown, which has in turn given way to a global economic downturn; the rise of populist politics, best illustrated by Donald Trump's accession to Republican presidential candidate; a slump in oil and commodity prices (admittedly now showing some signs of growth again); and the EU referendum – a combination described by George Osborne earlier in the year as "a toxic cocktail of threats".

However, regulation has come out as a big issue. Whether it be implementing the requirements of Solvency II, meeting the statutory capital ratios of Basel III or the strictures of the Senior Managers Regime and MiFID II, Financial Services firms have been hard pressed to maintain profitability and commercial focus in the teeth of regulation coming out of both the UK and Brussels.

A clear call to action has issued from the interviews we've conducted over the last two months – reduce the regulatory burden and cut the red tape which is strangling innovation and a healthy degree of risk taking. Critically, in the context of the referendum, this should be done in concert with the EU.

Other major issues of concern are cybercrime and data breaches. We have not seen the last major cyber attack on Financial Services firms and this is clearly a major board level issue for many businesses sitting on a significant amount of highly confidential data.

That said, there is a consensus too that the second half of the year will be more positive – a sanguine outlook that is surely linked to confidence that Britain remains in the EU and flourishes within it. With the uncertainty removed, there is little reason to think this shouldn't be the case.

I hope that you find the report of interest and that it resonates with your own experiences, both in terms of the challenges and the opportunities facing senior leadership of our major Financial Services firms. Respondents were asked how the City can maintain its preeminent position as the world's leading financial centre – I hope their insights provide food for thought in this regard.

Simon Hearn
Chief Executive

EXECUTIVE SUMMARY

City-based Financial Services **Chairmen and CEOs are overwhelmingly in favour of staying in the EU**, with 88 per cent wishing, on balance, to remain.

The vast majority do not seem to be deterred from building out their businesses by the vote on the UK's relationship with the EU, with 88 per cent of respondents saying that they are not holding back from making major investments before the EU referendum. This suggests a high degree of confidence either in a Remain victory or that they will be protected from any negative fallout from a "Brexit". It could suggest an element of complacency too.

92 per cent said that **cyber risk constitutes a major concern**, with the remaining 8 per cent saying it is a slight concern.

Data breaches via external attacks are the biggest worry for Chairmen and CEOs, with a third of respondents (32 per cent) being of the opinion that **"cyber extortion" is the greatest concern**.

82 per cent said that they expect to see **more shareholder activism** around remuneration this year. One described the atmosphere as "febrile".

Almost two thirds (63 per cent) of respondents said that the **Senior Managers Regime (SMR) will deter people from seeking the top financial jobs**.

Over two thirds (69 per cent) said that Article 275 in Solvency II has made their **remuneration requirements** "a lot more onerous" or "slightly more onerous".

90 per cent of CEOs and Chairmen are either not very concerned or **not at all concerned about FinTech companies luring top talent away** from traditional Financial Services players.

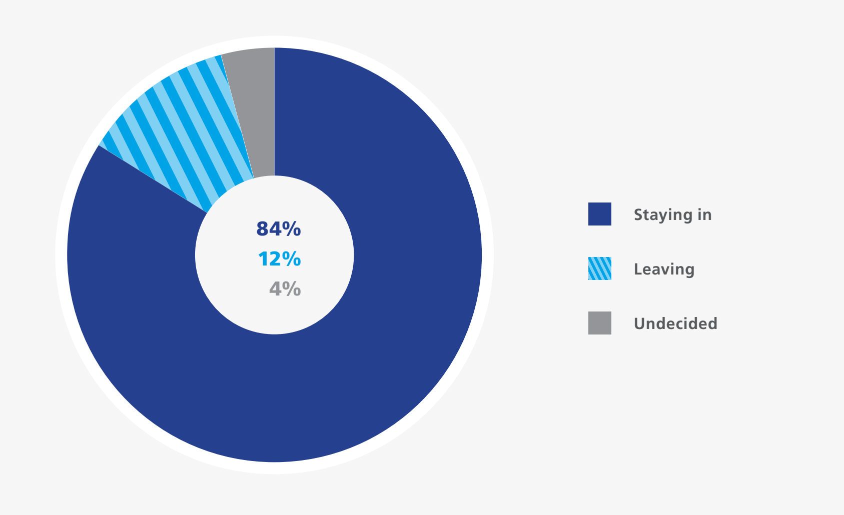
92 per cent said that cyber risk constitutes a major concern, with the remaining 8 per cent saying it is a slight concern.

82 per cent said that they expect to see more shareholder activism around remuneration this year. One described the atmosphere as "febrile".

The vast majority do not seem to be deterred from building out their businesses by the vote on the UK's relationship with the EU, with 88 per cent of respondents saying that they are not holding back from making major investments before the EU referendum.

The EU referendum – not a major deterrent of investment for Financial Services firms

On balance, are you in favour of staying or leaving the EU?



Our view is that the City's pre-eminence as the world's greatest financial hub is dependent upon its access to the single market and the world's largest trading bloc.

The EU referendum on 23 June 2016 is widely viewed as a seminal moment in British history and will be viewed as such by posterity. Per Ardua believes that the interests of the UK and its Financial Services sector are best served by remaining within the EU. Indeed, our view is that the City's pre-eminence as the world's greatest financial hub is dependent upon its access to the single market and the world's largest trading bloc.

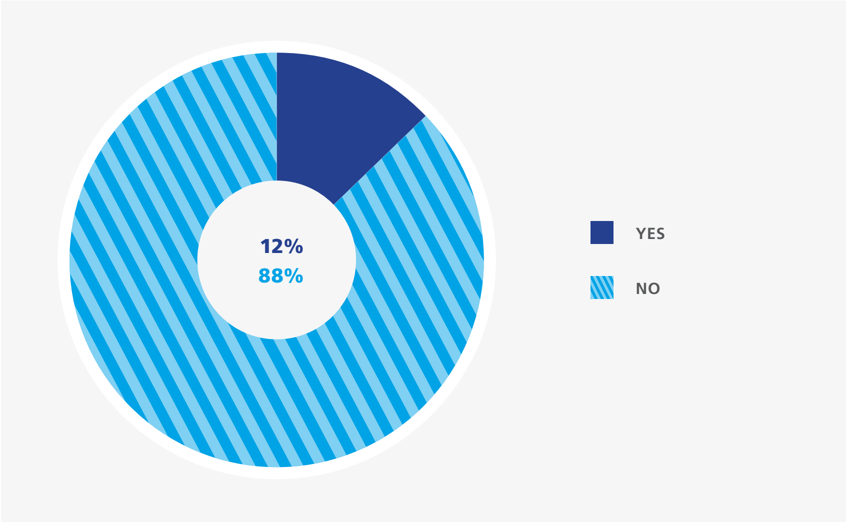
*" **The two-year period will see a stall and be very bad for us**"*

*"**I am a very reluctant stayer.** The EU really frustrates me but I suppose we have to stay and I will vote for that"*

*"If we weren't in I would question why we should join – **we are in and we should stay**"*

Notwithstanding our own position on the referendum, we sought to find out what Financial Services Chairmen and CEOs believed, on balance, was in the best interests of their business. The results were overwhelmingly in favour of staying in the EU, with 88 per cent wishing, on balance, to remain.

Are you holding off making any major investments until you are sure of the outcome of the EU referendum?

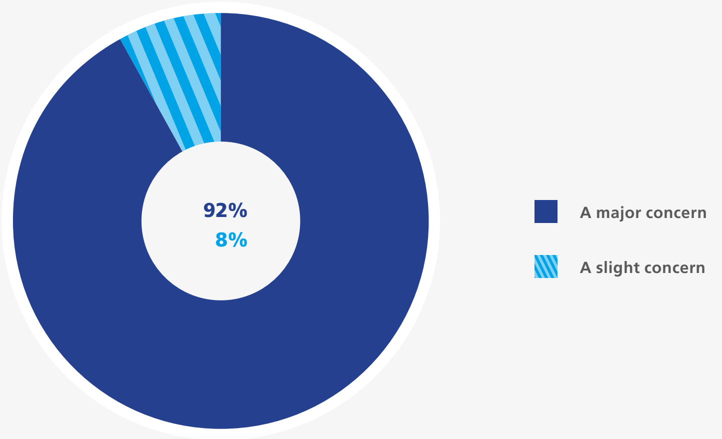


The fact that 88 per cent of respondents are not holding off making investments because of the referendum suggests that they are very confident that the result will be favourable to their business.

This discovery that most Financial Services companies haven't been holding off making investments, however, flies in the face of received wisdom and the many polls conducted over the last three to six months, which have suggested that non-Financial Services businesses are holding off investments until the second half of this year. Clearly this is not the case for Financial Services firms.

Cybercrime – one of the boardroom's biggest concerns

How big a concern in the boardroom is cyber risk?



"We worry about it a lot" – FinTech Chairman

"You can't just throw money at it…and [hope] it goes away … [cyber risks are] a huge concern for all. There are a lot of unknowns as to how big this can be".

Taken as a whole, cyber risks appear to be looming large on the list of principal concerns for Financial Services boards. Whether it be risks relating to cyber extortion, industrial espionage, employee error or an internal attack, it is clear that cyber issues are not only considered business critical, but they appear to be causing Chairmen and CEOs a good deal of worry about the existential threat that they pose to their businesses.

When asked how big a concern cyber risk is, they responded unequivocally that it was not merely a slight concern, but in the overwhelming majority of cases respondents admitted that it was "a major concern" to their boardroom. 92 per cent said that cyber risk constitutes a major concern, with the remaining 8 per cent saying it is a slight concern. Tellingly, no leader viewed cyber risks as being "not concerning at all", illustrating just how far up the list cyber risk has moved in recent years

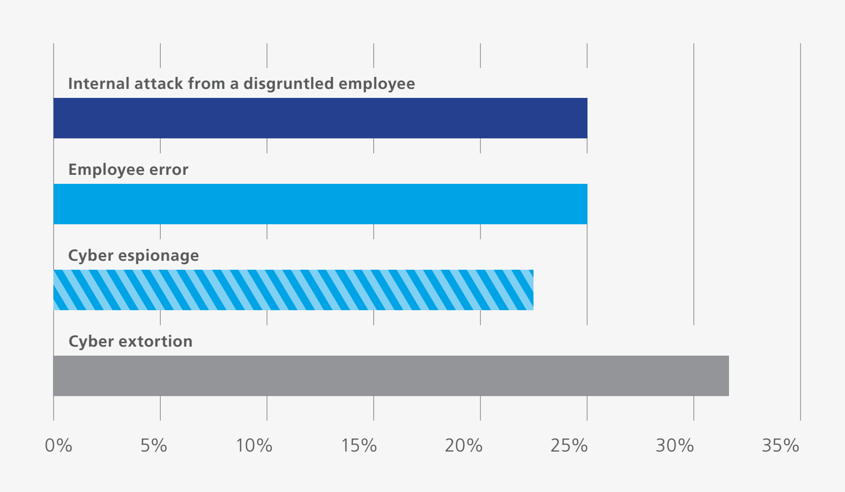
In terms of what boards intend to do to combat these risks, anecdotally it is apparent that this regular board topic is going to get an uptick in investment. This is exemplified by the words of one senior insurance executive who said that "the Board and Risk Committee have had at least three big conversations on cyber attacks this year and will be spending a lot on protection going forward".

However, there is an acknowledgement that "you can't just throw money at it…and [hope] it goes away". As such, most Chairmen and CEOs we spoke to admit, as one put it, that "[cyber risks are] a huge concern for all. There are a lot of unknowns as to how big this can be".

The biggest cyber concern?

"The scariest thing is a successful attack from a hacktivist source which undermines client and/or counterparty confidence; this might be ideologically or criminally motivated, or increasingly a combination of the two."

Which cyber risk is the biggest concern?



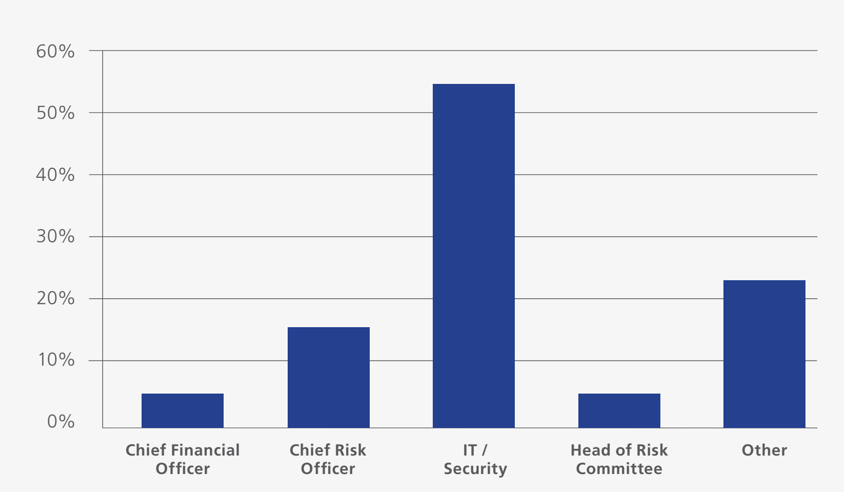
Having ascertained that cyber risks are of significant concern to Financial Services leaders, we sought to gauge what the specific threats were and how they ranked in order of importance. It is evident that data breaches via external attacks are the biggest worry for Chairmen and CEOs, with a third of respondents (32 per cent) being of the opinion that "cyber extortion" is the greatest concern. When "cyber espionage" – voted for by almost a fifth of respondents (18 per cent) – is added to this, it is clear that cyber attacks from without are as much of a threat as attacks from within. The reasons behind this viewpoint are hinted at by the following statement by one CEO, who opined that "sophisticated crime rings are the threat of the future".

"Sophisticated crime rings are the threat of the future".

Whilst internal attacks or employee errors, which can have significant reputational and commercial ramifications, remain a concern, it seems that the bigger threat is deemed to be cyber criminals or so-called "hacktivists". As one banking Chairman put it: "the scariest thing is a successful attack from a hacktivist source which undermines client and/or counterparty confidence; this might be ideologically or criminally motivated, or increasingly a combination of the two". Ultimately, all respondents were worried about every type of cyber risk to varying degrees – clearly this is a major challenge for Financial Services in the years to come.

Who is responsible for protecting companies from cyber attacks?

Who is responsible for cyber security / data protection within your organisation?



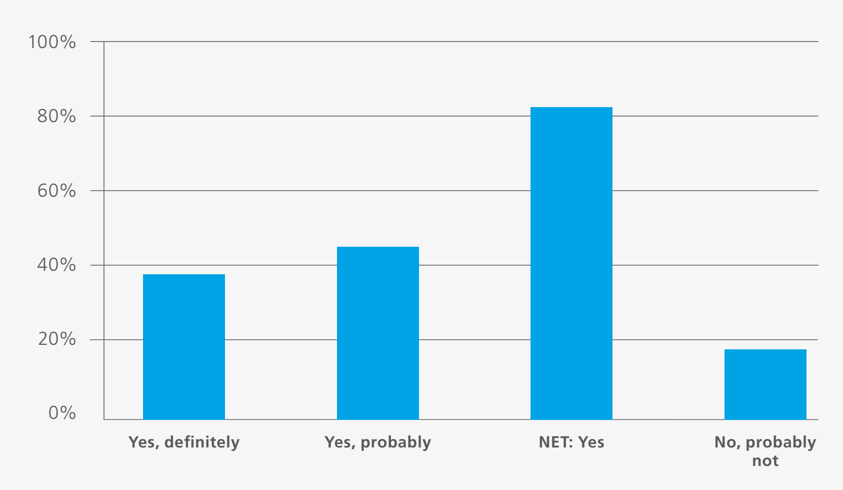
"This is responsibility and accountability. With us the former is the CIO and the latter the CEO."

Finally on cyber risks, we wanted to ascertain who, in Financial Services organisations, is in charge of all matters pertaining to cyber risks. The majority of respondents (54 per cent) said that the Head of IT or Head of IT Security was responsible. However, 54 per cent is hardly a consensus, something which indicates a lack of standardisation as to who oversees cyber security for the business. The next most cited person was jointly the CEO and the Chief Risk Officer, two very different roles and areas of responsibility.

"We have a Head of Information Security. We also have rigorous oversight by the Risk Committee."

Shareholder activism – knives out for remuneration

Do you think that there will be more shareholder activism against remuneration this year?



*"**I don't see much change in attitudes here**: if you get in the faces of shareholders by doing stupid things, they will come looking for you."*

*"**People will sometimes vote "no" to remuneration** even when it's not in their interest."*

*"**Without a doubt, this will get a lot worse.**"*

Asked if the industry is poised for another bout of discord, with investors throwing out remuneration committees' recommendations on pay, 82 per cent of our respondents said that they expect to see more shareholder activism of this kind. One described the atmosphere as "febrile".

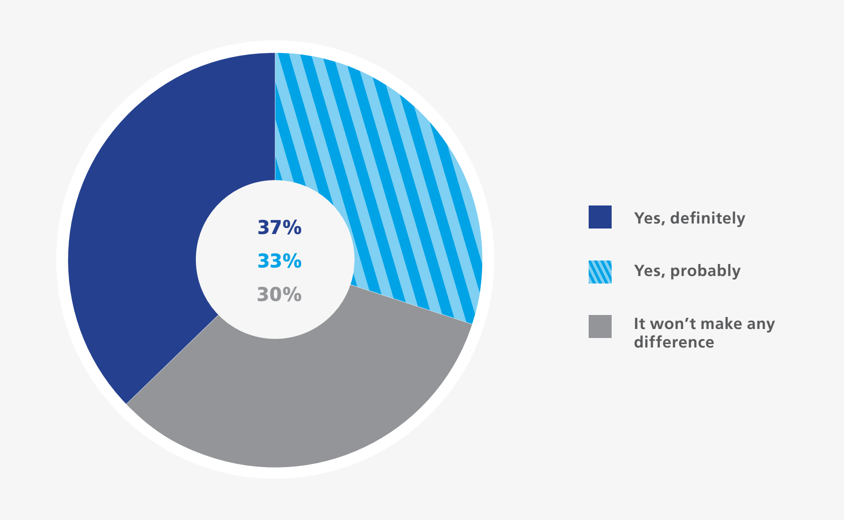
One of our sample group said "NEDs are in a terrible position here", with others suggesting that executives will exercise much greater caution before joining boards for fear of seeing their packages blocked. That eventuality, they said, leaves the personnel affected with no option but to go elsewhere. They were not without criticism of the sums that Remuneration Committees try to get passed by their investors, however, with one citing "past and present greed" to explain shareholder resistance and others stating that CEOs and senior executives are still paid too much.

While some believe that Remuneration Committees should do a better job, and that activist shareholders are performing a valuable function in holding them to account, other factors are at play. Some mentioned the role of voting consultants, expressing concern over their power and lack of accountability, while others point to the changing shape of the investor base – specifically the internationalisation of shareholder groups.

One respondent complained that regulation is "too tight and too specific" but a near consensus exists in the expectation that this problem will not go away any time soon. "Without a doubt, this will get a lot worse," said one member of our sample group, especially when compensation does not move in line with share price performance. Another, however, complained that shareholders' actions are not always logical: "people will sometimes vote "no" to remuneration even when it's not in their interest."

The Senior Manager's Regime – a deterrent effect?

Is the Regulator's recently implemented Senior Managers Regime going to deter people from seeking the top Financial Services job?



The long-awaited Senior Managers Regime (SMR) for Financial Services is likely to have a negative impact on an industry already concerned about the availability of qualified people for the most senior and responsible roles. Asked if the SMR will deter people from seeking the top jobs, almost two thirds (63 per cent) of the group who answered the question said that it will.

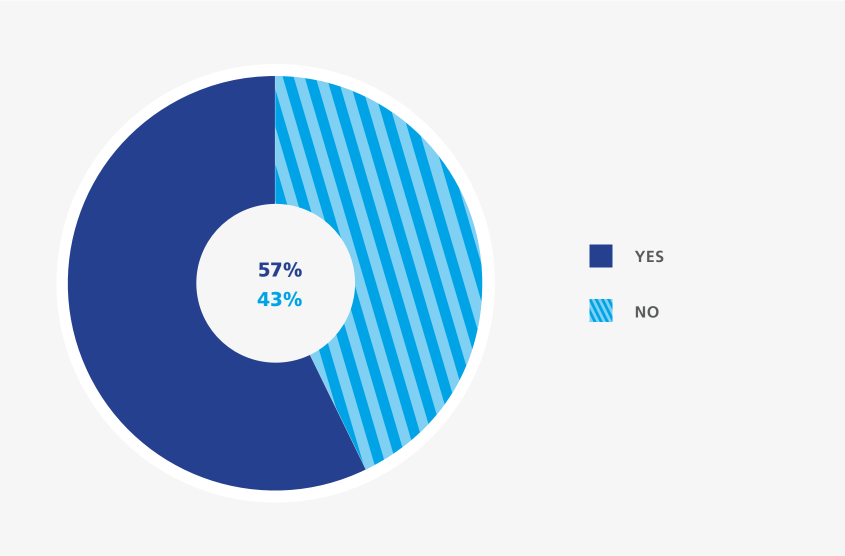
As ever, the headline numbers disguise a variety of views. Some, for example, believe the impact will lessen once there is greater clarity as to what the new regime will mean in practice. Others believe that, if it is sensibly applied, the regime will not have an impact long-term.

Many, while supportive of the aims behind the SMR, are concerned about its implementation at a time when demand for qualified people is increasing, thanks to the ring-fencing of retail banking operations and the expanding FinTech sector's requirement for experienced personnel. Many of our respondents share the fear that candidates for Non-Executive Directorships in particular, will be deterred by the levels of responsibility in industries covered by the regime and simply opt for positions in less intensely regulated sectors.

Interestingly, when asked whether SMR will change behaviours in the boardroom, only 57 per cent believe that it will, with the remainder opining that it wouldn't, in spite of the fact that the regulation is designed specifically to ensure that behaviours change for the better.

One respondent sees it as a helpful means of helping to ensure that the right people are attracted to senior posts.

Do you believe SMR will change behaviours on your board or executive?

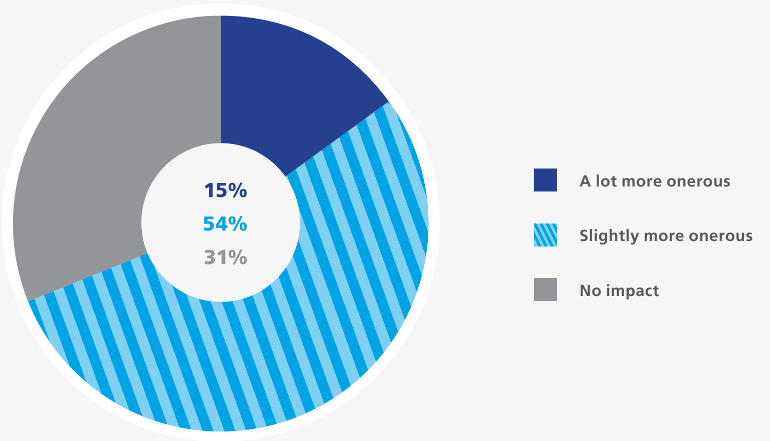


Among the significant minority of respondents who do not foresee a change to senior recruitment as a result of the SMR, there are those who see it as overdue – one respondent, for example, told us that the regime simply codifies standards that were already in place. People on that side of the argument view the regime as a net benefit to their industry. One respondent sees it as a helpful means of helping to ensure that the right people are attracted to senior posts: "the right people won't be put off," he told us.

*"**This will really hit the NED fraternity – that is what really worries me**, because of what the regulator expects the NEDs to do."*

Solvency II – a major impact for executives and boards?

Have the recently implemented Solvency II remuneration requirements (Article 275) impacted your exec and board?



The implementation deadline of 1 January 2016 for Solvency II has now long since passed. Six months on, we wanted to find out from insurance CEOs and Chairmen whether the remuneration requirements found within the new regulatory framework (Article 275) had yet impacted their executive team and board.

The results suggest that Solvency II has made remuneration requirements more onerous, with over two thirds (69 per cent) saying that Article 275 has made their remuneration requirements "a lot more onerous" or "slightly more onerous".

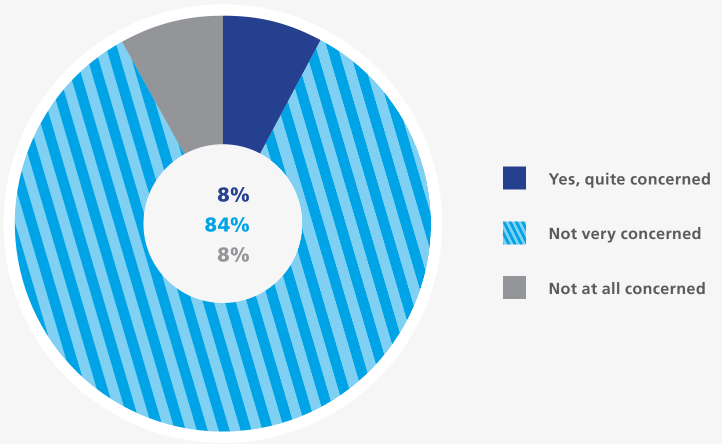
Furthermore, beyond simply finding out the degree of impact, if any, that this has had on insurers, we wanted to discover in what way Solvency II has changed remuneration practices. The consensus which emerged from our interviews indicates that the rise of long term incentive plans (LTIPs) or deferred bonuses will have a major impact for the executives and the board, suggesting that the demise of the annual bonus may be putting people off joining insurance boards. One Chairman put it succinctly, saying:

"A lot of pay will be deferred for five years. ***It will have a huge impact*** *... both for Executives and also the Board."*

Having said that, there is a degree of acknowledgement that, although Article 275 has made remuneration requirements somewhat more onerous, most of it "is needed" and it has helped "level the playing field".

The lure – or otherwise – of FinTech

Are you concerned that some of the industry's top talent is being lured away from traditional financial players to newer FinTech start-ups?



> *"This is a **typical cyclical phenomenon** which needs to be allowed to play itself out."*

It is fast becoming received wisdom that the financial technology sector is likely to attract potential Non-Executive Directors and others, leading to a reduction in the availability of qualified senior staff in more established corners of the Financial Services industry. This dynamic has been cited in answers to previous questions but, when asked specifically about it, our respondents are largely unconcerned.

Of the Chairmen and CEOs who have a view on whether top talent is being lured away from traditional firms, a majority of more than 90 per cent are either not very concerned or not at all concerned. Respondents point out that the advent of technology is not a new thing for Financial Services, and that it is likely to be a net benefit. One believes that "conventional" NEDs and Chairmen are likely, in future, to have at least one FinTech firm in their portfolio of roles, while others see FinTech's rise – and its effect on senior recruitment – as "overhyped".

Respondents are more evenly split on the question of whether FinTech companies are made vulnerable by their lack of board-level expertise. Of the individuals who answered, a slight majority of one evince some concern, but only two said they are very concerned.

Some believe that these firms will attract senior-level expertise once they have become sufficiently established – a development they expect to follow a period of consolidation, as some FinTech companies fail – while others are concerned that they will not attract the right people fast enough once they achieve prominence. One respondent said the sector will be "massively exposed" to this risk once firms find themselves on the regulatory radar. Others express milder concern, with one suggesting that without "grey hairs", FinTech businesses are likely to cut corners.

CONCLUSION

Remain in the EU, protect ourselves and regulate smarter

We need to encourage regulation that really understands how Financial Services firms can run into trouble

Within a week of this survey report hitting your inbox, we will all know what the country has decided regarding the UK's future relationship with the European Union. One outcome will help to maintain the strength of the City – the other will have the opposite effect.

More broadly in the world of Financial Services, while many of the stress factors in sourcing, recruiting, compensating and retaining board-level staff remain, the news is not all bad. In particular, it is encouraging to see that some of the gloomier received wisdom appears to be unfounded. The demand from FinTech companies for experienced senior people is seen as a welcome opportunity, for example, rather than a problem.

A similar mixture of positives and negatives is also evident in the answers to the final question in our survey: What can the City do to adapt or innovate to stay ahead of the major global financial hubs?

Regulation, inevitably, remains a prime concern. One of our respondents complained about excessive rule-making that stresses form over substance, just one of many eloquent calls for the regulators to take a more considered approach. Our group is not opposed to regulation in itself, but wants to see standards applied that help the industry perform to its full potential.

One said: "We need to encourage regulation that really understands how Financial Services firms can run into trouble – too much trading between themselves, too many leverage asymmetrical remuneration structures that reward people for gambling with other people's money but impose little or no downside."

While one complained that the FCA is actively making the City a less attractive place to do business, this is by no means a consensus view – another respondent said banks are being too slow to enact new rules. Many are confident that Andrew Bailey will be a force for good.

While numerous extraneous influences are being felt, the industry is by no means a passive actor in the shaping of its own future. Our respondents' prescriptions for how the sector at large and individual firms can guarantee success are numerous, but several common themes have emerged.

Cutting operating costs remains key, with restraint on compensation an important part of the exercise, but the message is not solely a defensive one – our group also wants to see the industry looking to expand with confidence.

Headwinds remain, but with supportive regulation and corporate strategies focused on the efficient pursuit of innovation, the best for the City could be yet to come, but only if we vote to remain within the European Union.

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