2014: LIVING IN THE SHADOW OF REGULATION?

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CONTENTS

FOREWORD 5

BACKGROUND TO THE CRISIS 6

A low interest rate climate 6

Bad housing policies 6

Mis-selling 7

Capital adequacy 7

The role of the alchemists 7

The rating agencies 8

The professional fund managers 8

Hedge funds and their use of derivatives 8

Why banks go bust 9

THE CRASH 10

TED Spread measures the shock 10

Containing contagion 11

Central bankers print money 12

THE REGULATORY REFORM 13

The Ring-Fence 15

Corporate Governace 15

Reining in risk 16

Payday Loans 16

THE SOLUTIONS 17

Consequences and challenges for banks minimising business disruption 17

Prioritising investment in resource and training 17

Reduced returns on capital 18

Impact on profitability on a risk-adjusted basis 18

Create a framework to tie regulatory reform programmes to the bank's overall strategy 20

BASIC APPROACH 21

ABOUT THE AUTHOR 24

FOREWARD

The UK Government has introduced the biggest reforms to the banking sector in a generation to make banks more resilient to shocks, easier to fix when they get into difficulties, and to reduce the severity of future financial crises.

The reforms aim in particular to reduce the impact on retail customers and the need for taxpayer bailouts when banks make losses.

Implementing the changes will require banks to make substantial and transformative adjustments to their strategies, operations and governance structures. Banks should view this as an opportunity to think holistically and address the underlying causes of failure.

Basel II failed precisely because it allowed banks to comply with the letter of the regulations while flouting its spirit. It is our view that good business is simple business; banks should aim for clarity and transparency in their dealings and above all to generate value for clients and their own business in equal proportions, whilst removing any non value-adds. If implemented well, such a strategy could more than offset the cost of compliance.

Sustaining competitive advantage will require a mind shift away from the short termism that led to the crisis, which cost banks their reputations and a whole lot more, to a more client-centric business model.

Let us begin by reviewing several important features of the period leading up to the financial crisis:

A LOW INTEREST RATE CLIMATE

At the turn of a century a sense of inflated optimism drove the economy. Demand for property was fuelled by the availability of historically low-cost funding, deregulation and financial innovation.

The “Greenspan Put” in the wake of the economic slowdown following 9/11 assured speculators that the US Federal Reserve would, in the event of a crisis, help investors by lowering interest rates. This hedge led to a willingness to assume high levels of risk, which was ultimately responsible for the credit bubble.

Banks and investors became excessively leveraged in their attempts to manufacture acceptable yields in a low interest rate climate.

BAD HOUSING POLICIES

The US Government indirectly supported the private real estate market for decades. After the Great Depression, policy-makers devised regulations to prevent a recurrence. The Glass-Steagall Act of 1933, requiring the separation of commercial and investment banking, meant that deposits could no longer be used to play the stock market.

The creation of Fannie Mae (The Federal National Mortgage Association) in 1938 ensured that banks would always be in a position to grant a mortgage even if they were in financial trouble.

Fannie Mae partnered with banks and not directly with borrowers and in doing so it provided liquidity by buying home loans from mortgage banks, assuming the risk, and refinancing itself in the markets.

MIS-SELLING

The boom created tremendous growth opportunities for banks, which may help explain the general deterioration in the standard and quality of financial advice, together with a lack of financial literacy among a broad section of the mortgage-buying population.

"Teaser rate" loans were a particularly good example of mis-selling in this environment, essentially promoting the wrong, lower than actual price of the product.

They did a disservice not only to the client but also to the lender, who made a high-risk loan, caveat emptor accepted. The Midwest US subprime mortgage market proved to be so popular and easy to sell that it seemed everyone was selling mortgages either to supplement their income or to play the property investment game, with many low-income investors able to acquire property portfolios using high-risk, short-term credit card deposit funding.

CAPITAL ADEQUACY

In the early days of the pre-crisis period, bank balance sheet valuations appeared to be solid, in part due to mark-to-market rules that reflected what later proved to be an incorrectly priced CDO market. There appeared to be no immediate risk to the banks' capital positions.

A belief that there would be a perpetual demand for loans led to hubris. In an attempt to optimise the available capital securitisation helped banks to circumvent the spirit of Basel II's capital adequacy provisions whilst complying with the letter of the law.

THE ROLE OF THE ALCHEMISTS

Opportunities for fast growth tempted bankers to depart from the traditional banking model based on client relationship management and strong loan-to-deposit ratios, in favour of a more lucrative model of origination and securitisation. Banks essentially became marketing companies, simply promoting mortgages with no intention of ever holding a customer loan to maturity.

Ingredients for asset-backed securities (ABS) and collateralised debt obligations (CDO) leveraged return and risk 2,000-fold, which was then further leveraged with structured investment vehicles (SIVs), credit default swaps (CDS) and CDOs of CDOs.

Essentially the same equity capital funded multiple rounds of loan originations, a form of capital churning that creates little if any real economic value.

THE RATING AGENCIES

The low interest rate environment in the period leading up to the crisis offered professional fund managers poor returns on traditional fixed income debt. This created a market opportunity for investment banks. Financial innovations enabled bankers to package and sell even the highest risk-securitised debt (the equity tranche) to investors. To these professional investors asset backed securities seemed, on the surface at least, to offer an alternative investment, which gave high yield at an acceptable risk premium. This was made possible because rating agencies rubber-stamped these bonds with ratings that gave investors the confidence, and in many cases the mandate, to buy.

Rating agency valuations of CDO debt tranches were based on enigmatic models that were not readily open to public scrutiny.

THE PROFESSIONAL FUND MANAGERS

One of the principal failings of professional fund managers in this situation was in outsourcing essential due diligence on asset portfolios to the rating agencies: a lack of fiduciary duty of care to the very household investors that are the providers of funds in the first place!

HEDGE FUNDS AND THEIR USE OF DERIVATIVES

Banks, pension funds and sovereigns alike scrambled to acquire CDOs, CDOs squared and other synthetic mortgage-related derivatives. This frenzied period saw the acceleration of the market for credit derivatives. Credit default swaps (CDS) were being touted to investors as a safe hedge against CDO credit default risk. Unfortunately, the blends of risk were opaque, it was impossible for any bank to accurately value these instruments, let alone price insurance protection.

The ratings were used to do this but premiums, which generally should reflect the cost of risk, failed to do so, as the ratings were based on faulty models.

This fact itself spawned pricing arbitrage opportunity later for astute hedge fund investors such as the infamous Michael Burry of Scion Capital. The mortgage pools that Burry shorted had delinquencies of up to 33%. By 2005/6 teaser rates were already ending, delinquency rates were rapidly rising, but Wall Street remained long and wrong.

WHY BANKS GO BUST

Loans were originated with the intention of removal from the balance sheet in a relatively short timeframe. This encouraged some bankers to rely on short-term interbank funding to finance loan growth, a very high-risk approach.

But if history has taught us anything it is that banks tend to go bust when they hold too little capital. Leverage, the process of funding income-generating assets with both equity and debt, is the single most effective way to increase return on equity (ROE). ROE is arguably the most important performance metric for a bank and its investors, with both investor returns and banker bonuses being closely aligned to it. Unfortunately ROE does not account for risk.

Leverage can therefore magnify returns but it can also magnify losses. The consequences of getting it wrong can have a devastating effect on the capital position and the solvency of a bank.

Profit after tax (PAT), the metric commonly used to calculate ROE, does not account for risk. Risk adjustment to profitability is achieved by applying a charge to risk, allocated equity at the cost of equity, to derive what is referred to as an economic profit (EP) metric. EP, unlike ROE, is an absolute number which represents the minimum return required to satisfy shareholders. Unfortunately many banks and investors focus too heavily on the non-risk adjusted ROE.

THE CRASH

On 9 August 2007 banks stopped lending to each other. They were over-extended. Banks lost confidence in the system as a whole.

TED SPREAD MEASURES THE SHOCK

The TED Spread measures the difference, in percent, between the market rate on three-month Treasury Bills, considered the safest in the world, and three-month LIBOR, the rate banks lend to each other in the money markets. In the money markets banks lend to each other with no collateral whatsoever. In the past, when banks trusted one another, the interbank lending rate was the lowest in the market, not unlike the interest rate for government bonds. But a wide gap had developed between the two rates since the crisis erupted. As such the TED Spread was considered the most reliable seismograph of the crisis.

The more recent scandal over LIBOR has led to new measures to ensure that banks lending to each other is controlled, transparent and fair.

As credit default rates continued to rise exponentially, demand for CDS insurance rose sharply. It became apparent to organisations such as AIG, Bear Stearns and Lehman, who were all over-exposed, that they were in deep and unexpected trouble, each requiring central bank intervention and taxpayer assisted bailouts. Lehman was allowed to fail, AIG received an $85 billion taxpayer bailout and the IMF predicted a $1 trillion write-off for banks.

Bear Stearns collapsed on 10 March 2008 after a run on its funding supply by the market and by 16 March 2008 it had been quietly acquired by JPMorgan with the help of a $30 billion taxpayer bailout.

Banks and investors with exposure to subprime would suffer the greatest losses. The Basel II regulations proved to be wholly inadequate in preventing the failure of banks and no mechanism was in place at that time for orderly resolution of a bank deemed too large to fail.

For a variety of reasons related to central banker policy and regulatory constraints a number of banks did not receive assistance in time, a slowness of response that caused some reputational damage for the likes of Mervyn King and Ben Bernanke, and led to the fire sale of Lehman and Northern Rock, events which many argue were big mistakes.

A key feature of the new regulation will be implementation of measures to ensure the orderly resolution of banks – there will be no too large to fail.

Of course, businesses do fail so we might have asked what was the big deal. However, unlike many businesses, banks are interconnected to the growth and health of the wider economy and when a large bank fails, it can bring everything else down with it.

CONTAINING CONTAGION

The near-collapse of AIG sent tremors through the financial markets that would eventually spill over onto Main Street. It was not possible to contain the contagion! The National Bureau for Economic Research declared that the US recession had officially started in December 2007, based on a series of indicators, such as growth, production and employment. Reports surfaced from manufacturing companies worldwide, warning about a sudden drop in orders. In the US the car industry found itself in trouble. In Europe and Asia too, the crisis suddenly began to reflect the real economy. And at that point it became a political issue. Most economists at that time were still predicting a mild recession, however by November and December 2008, the global economy deteriorated at a pace not seen since the great depression. In three months alone, global trade volumes were down 20%.

Conditions seemed to improve towards the end of the year and policy makers became more hopeful that an economic meltdown could be avoided. But as the year drew to a close and ever more banks disclosed subprime related losses, nervousness increased again.

In an unprecedented coordinated action on 12 December the Bank of England, the European Central Bank, the US Federal Reserve, the Bank of Japan and the Swiss National Bank announced that they were prepared to pour billions into the money markets. This was intended to keep the global economy healthy through a tricky period, but brought only short term relief; central banks found themselves repeating the exercise in March 2008.

Confidence in the banking system was gone, undisclosed losses were mounting on balance sheets and distrust was widespread. Globalisation meant that the banking crisis could not be contained in one market.

From Los Angeles to London banks turned business away, lending limits were cut and rates increased. Overnight it became harder to get a mortgage and available mortgages suddenly became a lot more expensive. Lenders reshuffled their loan portfolios and re-priced risk tracker deals. Trackers linked to the interbank rates rose sharply. LIBOR had decoupled from the official rate by some 200 basis points and special deals all but vanished.

CENTRAL BANKERS PRINT MONEY

The Fed allowed short term interest rates effectively to fall to zero in November 2008, having hit the "Zero Bound". Short-term rates cannot go below zero, and at that point alternative strategies were adopted in support of the economy. The Fed commenced a policy of quantitative easing (QE), more commonly known as "printing money".

The failings of the Basel regulations and the behaviours that led to the crisis were manifold, and this is now reflected in the new regulatory reforms, the exact nature of which is being determined by the jurisdictions within which the banks reside.

THE REGULATORY REFORM

To safeguard their financial stability and make it less likely that they will collapse in the future, large financial institutions need to build up enough high quality capital to cover their own losses and make sure that they are not at risk of insolvency.

As it won't always be possible to prevent institutions from failing, it is also necessary to have agreed principles and processes in place that will allow for timely and orderly resolution that does not unduly affect national economies. Given that large banks and other financial institutions operate globally, the UK will work with other countries and international organisations to agree an international approach to this issue.

- The UK Government is taking part in international discussions within the EU, the G20 and the Financial Stability Board about how they can respond more effectively to financial risks in the global economy. Its current proposals for banking reform are based on the Independent Commission on Banking (ICB)'s recommendations, the main points being: Globally coordinated system of macro prudential regulation
- No too large to fail: 'Orderly Resolution'
- Global forms of governance

The Banking Reform Act received Royal Assent in December 2013. It will bring into law structural and cultural changes to the banking system:

- Banks will be required to put a ring fence in place that protects customer deposits from trading floor activities.
- The failed tripartite system of macro prudential oversight has been replaced by two new authorities that work under the Bank of England and the Treasury:

  1. The Prudential Regulatory Authority (PRA) will hold banks to account for the way they separate their retail and investment activities. The PRA will have the power to enforce full separation of individual banks.
  2. The Financial Conduct Authority (FCA) will impose higher standards of conduct on the banking industry by introducing a criminal sanction for reckless misconduct that leads to bank failure.

- Banks will be required to subscribe to the Financial Services Compensation Scheme, to protect depositors in the event any bank enters insolvency.
- The regulations will give government power to ensure that banks are more able to absorb losses by forcing them to hold more equity capital.
- There will be caps on payday lending.
- Regulation will make it easier for customers to switch between current account. Providers with a current account switching service, introduced in September 2013.
- Reforms will be made to the LIBOR process.

Regulations will be implemented in harmony with other global regulators to ensure regulatory arbitrage is avoided.

- Ideally, the regulatory response becomes an integral component of the strategy, rather than a standalone initiative.
- The best approach to complex regulatory demands is to organise them into common themes for implementation, with multiple regulations broken down into specific components so that the common aspects of multiple requirements can be dealt with in a single solution.
- There will be a focus on individual accountability, corporate governance, competition and long-term financial stability.

Let us now consider the main points of the act:

THE RING-FENCE

The proposal: The ICB has, according to its Chairman Sir John Vickers, pushed through reforms that have gone "further than most of the rest of the world".

Key to these is the introduction of a ring-fence that will separate retail banking from notionally riskier investment banking. On top of this, insured retail depositors will be given preference over other debtors if a bank fails.

The problems: As the US found with the Volcker rule banning proprietary trading, the devil is in the detail. Lawyers and bankers warn that ring-fenced banks' ability to offer derivatives and trade finance to small corporate customers will be reduced, as will be the banks' ability to do business with other financial institutions. Small banks could be prevented from accessing funding from ring-fenced banks. Ring-fenced banks would be unable to offer some more sophisticated products, such as structured deposits, to customers but smaller ones will.

CORPORATE GOVERNANCE

The proposal: The proposal for a new "senior persons" regime will bring tougher oversight for individuals, along with a certification regime for a broader range of staff. Senior individuals will be subject to a new criminal offence of reckless mismanagement of a bank. If a bank is found guilty of breaching regulatory rules, the individual in charge will have to prove that it was not their fault.

The problems: The regulator had previously vowed to improve its vetting of senior bank staff but that did not prevent Paul Flowers from becoming the chairman of a major lender, Co-operative Bank. However, experts say the new regime looks considerably more draconian. While the criminal sanction appears unlikely to be used, the burden of proof on the individual in charge is particularly tough. The authorities are anxious to prevent a rerun of the last crisis, when few individuals were held to account.

REINING IN RISK

The proposal: The Government has not gone down the road taken by the US, where the Volcker Rule has banned proprietary trading by banks. But the UK's Prudential Regulation Authority will prepare a report on proprietary trading soon after the ring-fence comes into effect.

The problems: The Volcker Rule is proving legally very difficult to put into full effect, so the UK can tentatively pat itself on the back for dodging that bullet. But that does not mean the ring-fence will be easy – lawyers are only starting to explore the complexities. There is a broader criticism of countries' attempts to curb the risks of investment banking: many of the big meltdowns of 2007-09 were caused by notionally less risky areas of retail banking, such as mortgage lending.

PAYDAY LOANS

The proposal: The Financial Conduct Authority will be under a duty to impose an overall cap on the cost of credit charged by short-term lenders such as payday loan companies. The regulator will have to work out the specifics of how this will be implemented.

The problems: The move was a U-turn by George Osborne, the chancellor, late in the legislative process and came in response to pressure on him to do more about the rising cost of living. The move could lead to pressure for the FCA to regulate a broader range of prices.

THE SOLUTIONS

CONSEQUENCES AND CHALLENGES FOR BANKS MINIMISING BUSINESS DISRUPTION

While there is a tremendous increase in regulatory activity, there is no specific framework for companies to follow in developing their regulatory response. Instead, companies should seek to create a new strategic framework of their own which would bring order and structure to the process.

There are multiple global regulations seeking to achieve similar objectives but working on different timelines. Most organisations focus primarily on the differences across the regulatory landscape.

Identifying commonalities will prove helpful to banks first by identifying the regulatory elements common to various requirements across relevant geographies and addressing them through an integrated approach to avoid reworking, confusion and unnecessary costs.

PRIORITISING INVESTMENT IN RESOURCE AND TRAINING

Many banks will be putting large scale change programmes in place over the next two years to be compliant with and responsive to the regulations. However, as discussed in this paper, regulatory requirement will, by definition, make some parts of the business more costly and/or less profitable over time.

The key to successful change programmes is to determine in which parts of the business the bank wants to remain (with the regulatory impact incorporated) and steer toward that future. It is highly unlikely banks will be able to keep the same business model and simply plan on absorbing the impact of the new regulations. Banks should also institutionalise capital performance measures within their business strategy if they are to support the overall success of such response programmes.

REDUCED RETURNS ON CAPITAL

The cost of compliance is high and increasing rapidly, but those organisations that institute a centralised, strategic regulatory response programme will have more control over managing and optimising their investment in compliance.

While banks recognise the importance of such programmes they will need a clear C-level executive sponsor for their regulatory response programme. Organisations will need to demonstrate the necessary rigour and commitment to ensure the change programme stays on course and delivers more than basic compliance.

IMPACT ON PROFITABILITY ON A RISK-ADJUSTED BASIS

The introduction of so many new regulations means that banks will have to set priorities in order to be effective in terms of their responses. There are simply not enough resources, time, money or people to address every tactical aspect of every regulation.

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A coordinated response also requires an assessment of the impact of regulations on each area of the business. For example, the Basel III/Capital Requirements Directive (CRD) IV provisions addressing capital requirements have a high potential impact on derivative transactions in particular, where higher levels of capital will need to be held to deal with the creditworthiness of the counterparties also known as the CVA charge.

However, syndicated lending will experience relatively low impact since minimal funding is required, which can potentially be incorporated within the pricing.

Bigham Consulting

New High Impact Framework

Peers

People

4Ps STRATEGY REVIEW

Performance

Process

ROE
EP
EVA

FINANCIAL REPORTING

Profitability
Risk/Liquidity
Balance Sheet

Shareholer & Other Stakeholders

GOVERNANCE

Executive Management

EPM

Human Capital Strategies
Employee Capability
Heat Map Analysis

ABC PROCESS ANALYSIS

INFRASTRUCTURE STRATEGIES
- Finance
- Information Technology
- Human Resources
- Legal Risk Capital
- Operations

Cost allocation

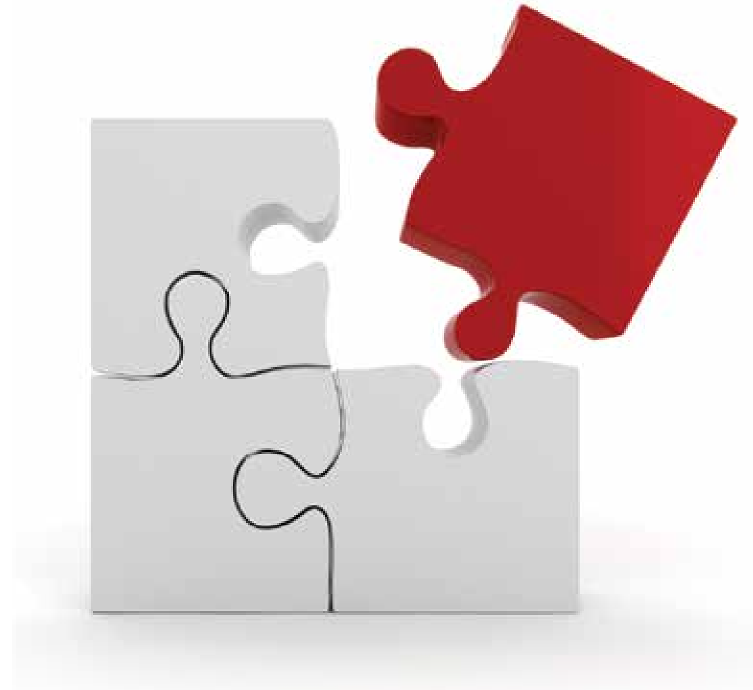
CTS
Cost to Serve Strategies

CORPORATE PORTFOLIO STRATEGY
- Product Manufacturing
- Marketing
- Sales & Trading
- Customer Services

In many cases, financial institutions have a raft of options regarding the implementation of responses to these new regulations. These options range from basic compliance to a comprehensive, optimised outcome which uses the regulatory response as a lever to make the needed changes to the business model. Banks should understand this concept and make deliberate decisions about the trade-off between compliance costs and the costs of achieving an optimised state across the spectrum of required regulatory changes with the support of the business leads for priority strategic system and process enhancements. These choices will not be easy, but banks must establish priorities and determine what resources and funding will be needed to reach these objectives through the appropriate path.

CREATE A FRAMEWORK TO TIE REGULATORY REFORM PROGRAMMES TO THE BANK'S OVERALL STRATEGY

Ideally, the regulatory response becomes an integral component of the strategy, rather than a standalone initiative. One of the best approaches is likely to be organising complex regulatory demands into common themes for implementation.



BASIC APPROACH

Essentially banks should aim to marry strategy, governance and enterprise performance management. To do this successfully would require banks to conduct detailed assessment reviews across a range of strategic dimensions that would underpin the development of an effective strategy going forward.

We advise a 4-stage strategy transformation approach that would help banks avoid running duplicating programmes and mitigate the cost of reform:

1. Leadership teams should aim to formulate a high level strategy that would aim to maintain or improve profitability, return on equity (ROE) and economic profit and shareholder value. The new regulation requires banks to monitor new metrics aimed at balancing liquidity and capital management. See our summary of Basel III.

2. The design of a suitable enterprise transformation blueprint must align the above strategic targets with departmental performance management.

3. Tackle multiple regulations by breaking them into discrete solution elements, so that the common aspects of multiple requirements can be dealt with in a single solution. To assist in this process, Bigham Consulting's High Impact Framework offers a robust structure within which enterprise strategy and governance can embrace strategic change initiatives and address these against the required timelines and desired outcomes.

4. The bank should assess the impact of each regulation on their baseline economic model. We recommend a careful alignment of implementation costs, product profitability, business process analysis and other fundamental economic drivers to the regulations as a whole against the desired strategy; chart a course to the business model that will enable that strategy and can be supported by an infrastructure which is robust enough for the requirements but also efficient enough to be affordable with the needed size, scope and flexibility.

In order to ensure that the organisation retains the broader perspective, it is important to take a business model view of the impacts of the change programme, highlighting the involvement of all areas and not just risk management and IT.

The financial institution can develop regulatory implementation programmes based on the business priorities to maximise returns from its required regulatory investment. For example, in strategic areas related to the business model and to establishing and maintaining a competitive advantage, programmes may be designed and implemented to separate retail from wholesale activities, to limit risks from proprietary trading, or to change the business model.

Another common functional component is technology, and here implementation programmes may be aimed at integrating finance and risk architecture, improving data governance and the overall quality of data, or sourcing and distributing reference data. Market initiatives might include linking with central counterparties for derivatives or developing solutions that more closely correlate collateral requirements with securities held and/or traded.

This is not to underestimate the implementation challenges posed by regulatory changes themselves. At a minimum, financial services firms will need to set up effective governance for their regulatory programmes, transform and align finance and risk functions, revamp current client on-boarding and data collection processes, establish stronger frameworks for operational risk, and develop crisis management plans.

In addition, regulations demand stronger efforts to curb financial crime, including anti-money laundering measures and development of client solutions for compliance with the Foreign Account Tax Compliance Act (FATCA). These encompass extended reporting structures and new know your customer (KYC) processes and will require a significant level of investment and resources for both U.S. and non-U.S. banks

Even organisations that choose only to meet basic compliance standards will have their work cut out. The desire is to create an approach which also returns tangible benefit to the organisation beyond the basics of overcoming these regulatory hurdles.

A comprehensive business assessment will help to align priorities; once identified these accountabilities should be embedded in the accountabilities of each affected department leader’s “Primary Scorecard”. This will assure the alignment to enterprise strategies (“The Senior Scorecard”), using the “High Impact Management” Enterprise Governance Framework.

There will be overlapping challenges to implementations, and demands will call for cross-functional project teams; For example, Dodd-Frank, Basel III, MiFID II, EMIR and CRD IV all have certain requirements or elements that will result in changes to the affected institutions. Doing so will necessitate coordination among the finance, risk, treasury, operations and technology functions, as well as the business lines themselves.

Governance of mandated regulatory response implementation will demand a similar level of coordination across key functions.

Bigham Consulting’s framework for implementing transformation strategy will help organisations rapidly get to grips with the challenges they face and formulate strategies that support both shareholder needs and enterprise governance.

ABOUT THE AUTHOR

Eric Bigham
Founder and CEO of Bigham Consulting

Founder and CEO of Bigham Consulting, Eric Bigham is a Strategy Consultant who helps business leaders formulate unique strategies to improve the profitability, return on equity (ROE) and economic profit that creates business and shareholder value.

He designs proprietary enterprise transformation blueprints that align strategic targets with departmental performance management and integrated governance solutions. Eric works closely with senior management teams to strategically review businesses to uncover the fundamental economic drivers of performance using a proprietary blend of people, process, peer and performance diagnostic tools.

His proprietary methodologies have proven effective and popular with corporate CFOs, heads of strategy and executive boards at many of the world's leading blue chip organisations during some of the most trying of economic times.

Prior to founding Bigham Consulting in 2009 Eric was a Management Consultant with Accenture. He has held senior finance positions in banking and industry and is a Fellow of the Association of Chartered Certified Accountants and a graduate of Kingston University.

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