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company

a future for business
which makes equal sense
to staff, shareholders
and society

A decorative graphic consisting of a series of purple ovals and dots of varying sizes, arranged in a pattern that suggests growth or a fan-like shape, extending from the left side of the page towards the center.

Restoring trust

Investment in the twenty-first century

An inquiry into the effectiveness of the UK investment system

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Foreword

Savings and investment form part of the central nervous system of a developed economy. The health of that system influences the behaviour and well-being of citizens and companies alike. The findings of this inquiry represent a vision of a better investment system, developed by those who work in it.

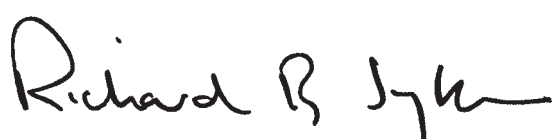
The context is one in which there have been many reports and reviews, and in which nothing stands still. Indeed, the details described in this report may soon be out of date, but the principles will endure. We set out the direction we would like the whole system to take in the years ahead. If we can agree on that, then we can all, in our own spheres, start to work towards it.

Throughout the process this Inquiry Team has tried to be constructive. We have listened carefully to practical people. We have weighed every new idea against the implications for the system as whole. We have been impressed by the many efforts being made to improve the operation of parts of the system. We want to build on these efforts, and create the conditions in which their purpose is fulfilled.

The task is so huge that the Inquiry Team has had to be selective. We have focused on five key areas for action. There are topics which we have not been able to examine in detail, such as start-ups, private equity and unquoted businesses. We have not chosen to examine the impact of the current tax system on investment. And, of course, we have concentrated upon the UK system while seeking to do justice to the implications of an increasingly global market for capital and companies.

Some may choose to read this report and ignore it. Others may come up with better ways of achieving the improvements we describe. The Inquiry Team is in no doubt that the system will have to change radically over the next ten to twenty years. The question is whether leaders in business, investment and financial services decide to work together to lead this change, or wait for regulators and politicians to shape it for them.

On behalf of the Inquiry Team I would like to thank all those who have contributed to the Inquiry consultation process and who have helped Tomorrow's Company with the initiation, management and completion of the project. It has been a privilege to be its Chairman.

A handwritten signature in black ink that reads "Richard B Sykes". The signature is written in a cursive, flowing style with a long horizontal stroke at the end.

Sir Richard Sykes

June 2004

Acknowledgements

We would like to acknowledge all those who have contributed to the creation, development, research and writing of this inquiry.

The Inquiry Team has not only led but also resourced the project by contributing finance, knowledge and expertise.

We would additionally like to acknowledge the contribution to the work of the Inquiry team made by Colin Melvin (Hermes), Stephen Spivey (DTI), Peter Moon and Raj Thamotheram (Universities Superannuation Scheme Ltd), Simon Wilkinson (London Stock Exchange), Pieter Steyn (Watson Wyatt) and all the personal assistants and support staff within the participating organisations.

The Research Faculty, listed overleaf, has comprised people drawn from these participating organisations and from the Research Board of Tomorrow's Company. We thank them for being an invaluable sounding board and a source of information, advice and answers.

We would also like to thank the organisations and individuals listed overleaf who have supported this work, and acknowledge the contribution of our Research Board and trustees. Thanks are due too to City & Financial, who were our partners in organising our Investment Summit in 2003; to SEMTA, the Science, Engineering and Manufacturing Technologies Alliance, for their generosity in undertaking the production of this report and to Jain Castiau and Esther Shickle at Cauldron Consulting Ltd for their marketing advice.

Restoring Trust was written by Philip Sadler, Programme Director; Patricia Cleverly, Head of Research; Arthur Probert, Research Associate and Mark Goyder. It was edited by Anne McMeehan of Cauldron Consulting Ltd. The organisation of the inquiry and its extensive research and consultation programme involved all members of the Tomorrow's Company staff team over the course of the inquiry, including Patricia Cleverly, Marcia Griffiths, Martina Masuch, Michael Mathres, Sabina Merran, Melody Slinn, Morag Thornton and Jo Ward.

It is impossible to thank them all individually, but carrying out the project would have been impossible without the goodwill and commitment of many people from the worlds of business, investment, government regulation and the relevant stakeholder groups.



Mark Goyder
Director
Tomorrow's Company
June 2004

Further copies of this document may be obtained from Tomorrow's Company:
www.tomorrowcompany.com

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Executive summary

Our aim in conducting this Inquiry has been to examine the effectiveness of the UK investment system and to put forward proposals for its improvement.

The inquiry is in essence an industry self-portrait. It is based on interviews and workshops conducted with over 500 people drawn from every aspect of the investment 'chain'. In formulating our proposals we have taken account of a number of government inquiries, industry reviews, trade body and company initiatives. However, unlike other studies, which have focused on particular sectors and issues, this takes a 'helicopter view' of the system as a whole.

We are acutely aware of the dangers of over-simplification and have not sought 'quick fix' solutions. Instead we have looked to prepare the way for a long-term agenda of improvement; a process in which we believe everyone in the investment system can collaborate.

The inquiry team's vision

Our vision is of an investment system in which:

- * strong investment performance is pursued over the long term by a focus on good business standards*
- * long-term investors (shareowners) and short-term dealers (shareholders) both have a place in a balanced market*
- * business is conducted transparently in order to promote trust and confidence*
- * long-term profitability is achieved by linking targets and incentives to the needs of investors*
- * investors and companies take the obligations of ownership seriously through ongoing dialogue*
- * customers are offered clear choices and have access to the necessary information to be in a position to choose.*

Our principal conclusion is that, while the whole system is relatively robust – and a number of reforms are still working their way through to strengthen it further – there has been a significant and continuing erosion of trust, not just in the financial services industry, but also in big companies as stewards of people's savings and pensions.

The financial services industry

The trust and confidence of investors have been damaged. There have been examples of herd-like behaviour, the creation of unrealistic expectations, lack of transparency and failure to manage conflicts of interest. The value added by active fund management is not always apparent. There are concerns expressed about the level of earnings within some City institutions, and questions as to whether they apply to themselves the same rigorous governance standards that they demand of quoted companies.

The methods used by some of those involved in investment and savings to achieve sales targets have also tarnished the industry's reputation. The approach has been sales-driven, not needs-focused. There is a danger that the overall investment 'cake' may therefore diminish, as people look for alternative means of providing for their future.

It is time for the financial services industry to focus on collaborating along the supply chain to create value for the ultimate customer.

A positive reputation is a primary source of competitive advantage – and within the global investment system the City of London has been respected for fair dealing. This reputation is a priceless asset, the benefits of which are enjoyed by all the various types of institution that make up the UK financial services industry. Yet this standing is at risk – as a direct result of the industry's own actions and shortcomings.

We believe that the industry now faces a stark choice – to take the initiative and set out to live by its own standards, or to lose further control of the agenda and be suffocated by increasing regulation.

Restoring trust in the financial services industry:

We are calling for an act of collective leadership on the part of those at the head of the major financial services companies. We are inviting them, as a matter of urgency, to work together to address the most pressing problems facing the industry.

Standards and principles

At the heart of our proposals is the creation of a forum for self-regulation. This would provide an arena at which leaders from all parts of the investment system might meet on a regular basis to address those issues key to the building of public trust and the development of a positive reputation for the industry. We believe that the first item on the agenda should be the creation of an overarching 'statement of principles' to cover all aspects of the industry and to which all parties can commit.

In our opinion, if this ‘statement of principles’ is to be meaningful, it would need to have teeth. The development of an industry-wide ‘seal of approval’ to support the statement of principles could provide both a visible and marketable endorsement, not dissimilar to that of the National House Builders Registration System or the travel industry via the Association of British Travel Agents. Where organisations were subsequently in breach of the principles, the ‘seal of approval’ would be withdrawn.

We believe that if an effective industry-wide forum were in place, bad practice might be spotted at an earlier stage, prior to regulatory intervention. Positive identification of potential malpractice by an attentive industry would not only help to offset the debilitating impact of regular assaults on the industry’s reputation; it would go some way to enhancing it.

However, the translation of fine words into actions can only take place at the level of the enterprise – where it has to start right at the top, with boards of directors or senior partners setting the example.

Alignment and transparency

We are concerned that there is a lack of alignment of the incentives and remuneration of the industry with those of the long-term interests of their customers; a lack of transparency in respect of industry charges and costs; and a failure to disclose and manage conflicts of interest.

In the area of pensions, progress in the implementation of the recommendations of the Myners report is under way and is, we believe, bringing about greater alignment of the interests and actions of pension funds, investment consultants and fund managers.

Our main proposals are that:

- * Incentives, including fees, should be more performance-related and transparent to all the parties to a contract; fund managers’ fees should be more dependent on performance than upon the size of funds under management.*
- * All parties operating within the investment system should disclose to their clients all fees and charges, including ‘hidden’ costs.*
- * Where it is not possible to manage conflicts of interest effectively, then ultimately, more radical solutions should be considered – at the very least, the management of conflicting roles within the same organisation should be separated and the value that each delivers to the organisation made clear.*
- * In future all providers of investment research should declare any relationships that might represent a possible conflict of interest.*
- * Providers of investment products should have the equivalent of an independent board or advisory group which reports regularly to investors or policy-holders with an assurance that investors’ interests have primacy in the investment decision-making process.*

We believe that unless the various players in the system improve the transparency and alignment of their operations and resolve the many conflicts of interest, they will lack credibility when exercising the rights and responsibilities of ownership.

Exercising ownership rights and responsibilities

Despite the encouragement of government and others, we believe that many of the fiduciaries representing companies' largest shareholders have largely abdicated their responsibilities as owners.

Our main proposals are that:

- * All institutional shareholders should comply with the Institutional Shareholders' Committee's 'Statement of the Responsibilities of Institutional Shareholders and Agents'. This sets out best practice for institutional shareholders and their agents in relation to their ownership responsibilities.*
- * The largest institutional shareholders should consider working together on a more formal basis to support the directors of companies in which they jointly invest in making decisions which are in the long-term interests of investors.*
- * Investment consultants should develop ratings and rankings of fund managers in terms of their 'effectiveness as owners' for use in 'beauty parades'.*
- * Institutional shareholders should make public their voting records.*
- * Institutional shareholders should identify their own potential conflicts of interest and put in place transparent corporate governance procedures to deal with them.*

The exercise of the responsibilities of ownership calls for constructive dialogue between investors and companies. Effective dialogue, focused on future value creation, demands that institutional shareholders develop a deep understanding of what drives a particular company's business success. Companies need to supply the right information, but investors and their agents also need to ask the right questions.

Evaluating long-term business success

Efficient markets require good information – investors need information which enables them to choose between different companies on the basis of their performance and prospects. The information should meet the following criteria:

- * Objectivity – free from distortion arising from conflicts of interest*
- * Accuracy – representing 'a true and fair view'*
- * Relevance – including all appropriate facts.*

To meet these criteria, analysis of a company's performance needs to be as complete as possible and take into account tangible and intangible factors and financial and non-financial information.

Our main proposals are that:

- * Fund managers should acquire a better understanding of, and use the body of knowledge about, all the indicators which inform the long-term future performance of companies.*
- * Independence of research should be reinforced to enhance the quality of information provided.*

- * In particular institutional investors should use this opportunity to close the evident gap between their own research processes and methodologies and those of the leading academic centres that focus on business performance analysis and measurement.*
- * Evaluation should be extended to cover a wider range of companies.*
- * Companies should present an integrated and ‘forward-looking’ view of the business, and in the process they should be allowed to present ‘forward-looking’ information. This is likely to broaden the dialogue between companies and investors, increase director accountability and give a more comprehensive picture of the company’s potential performance. The new statutory Operating and Financial Review provides an opportunity to do this.*
- * The potential to simplify the accounting and reporting model should also be examined.*
- * Media organisations should affirm and apply their commitment to the Press Complaints Commission Code of Practice. They should also publish their policy on areas of potential conflict of interest for financial journalists and have a system in place to ensure compliance.*

The ultimate investor is the private individual. Just as a better dialogue needs to be in place in order to improve the relationship between the institutional investor and the company in which it invests, a similar improvement needs to be established between the individual investor and the financial service provider or adviser.

The individual investor

The retail financial services sector has been plagued by a series of scandals. These are largely the result of providers promoting complex products to individuals who often lacked the skills to understand them or the risks associated with them. Yet attempts to protect the individual investor and to tighten regulation have sometimes been counter-productive; adding layers of extra cost and creating complicated compliance documentation that individuals find difficult to understand. We accept that the media have an important role to play in providing access to information about the industry to individual investors and their advisers.

We believe that a healthy retail investment climate is dependent on:

- * investor confidence in the market’s products and providers*
- * an industry with a reputation for fair dealing*
- * and a growing investor understanding of risk.*

Our main proposals are that:

- * The teaching of basic finance should be made compulsory in the school curriculum.*
- * The success of projects such as Young Enterprise, in which school pupils get to run their own ‘businesses’, should be built on.*
- * More complex financial concepts and how to plan for retirement should be made available in higher and adult education.*
- * Suppliers of financial products should take action to enable individual investors to develop a better understanding of risk.*

**The industry should aim to develop a classification matrix describing types of product and the associated risks.*

**As a way of building on current regulatory requirements investors should be kept regularly informed of all the underlying costs incurred in managing their assets.*

**‘The statement of principles’ proposed earlier, combined with the industry-wide forum, is the chief means by which the industry becomes proactive and committed to protecting the individual investor.*

Companies

The loss of trust also extends to the perception of the UK’s large companies. The public image of ‘big business’ is largely negative. Furthermore, the gap between those who own and those who manage companies has grown – in practice, leaving management less accountable; this transfer of greater power to management has too often been accompanied by behaviour which has been deemed inappropriate by shareholders’ representatives. This is not simply a question of governance issues, such as remuneration policy, but also acquisitions and corporate restructuring which have often resulted in little or no benefit to shareholders.

Restoring trust in companies

Corporate governance and shareholder relations

There is a considerable body of evidence revealing a link between the way in which a company is governed and its performance; in particular a link between active ownership and enhanced performance in those companies with the potential to improve. Shareholder engagement can therefore be a positive force, but it needs to be carried out with intelligence and integrity.

The UK Combined Code’s principles on shareholder and company dialogue call for companies to listen to their shareholders’ views and concerns and respond appropriately.

Just as individuals need more meaningful contact with providers of financial services, we believe there is similar merit in companies initiating a deeper and more strategic dialogue with their investors; they should also be bolder in setting out their long-term strategy.

Our main proposals are that:

In order to initiate a deeper and more strategic dialogue with investors, companies should:

** Issue statements outlining the long-term strategy of the company; the requirements of the OFR provide a useful starting point.*

** Create a dedicated space within the AGM, or hold a ‘strategy conference’ in addition to the AGM once every two or three years, specifically for institutional investors and representative intermediaries.*

Executive remuneration

Executive remuneration has become the focus of much debate and hostility over recent years. As a result, it is now subject to far more intense scrutiny – by the Association of British Insurers, the National Association of Pension Funds and other governance organisations and shareholder activists.

Nevertheless, there is continuing concern about levels of executive compensation, in particular the apparent lack of a clear relationship between performance and reward.

Our main proposals are that:

- * Companies should clearly explain the rationale behind their pay arrangements.*
- * Performance-related remuneration systems should be designed to ensure that the compensation of the most senior directors is not excessive relative to sustained performance and pay levels across the rest of the organisation.*
- * The performance-related remuneration of executives should be based on a greater weighting of shares against options to achieve better alignment with the performance of the company.*

Acquisitions and mergers

Research findings in 1999 showed that 83% of mergers and takeovers made by large quoted companies had failed to produce any benefits and over half had actually destroyed value. By 2002, the picture had improved, but only marginally. About 30% of deals created value, while 70% either destroyed value or made no discernable difference. Growth for growth's sake via takeovers has been a prime cause of shareholder value destruction.

Our main proposals are that:

- * When an acquisition or merger is put forward for consideration, the company's non-executive directors should always seek independent advice. Such advisers need to be free of potential conflicts of interest having no other relationship with the company.*
- * Companies should commission an independent review of the acquisitions they have made on a regular basis to assess whether the transactions did serve to create shareholder value.*

The underpinning role of government

As a direct result of the tax incentives offered to pension funds, and to indirect investors in the retail market, successive governments have steered the UK to a position of one of the highest proportions of corporate ownership by institutional investors in the world. Accordingly, the UK government takes a continuing interest in whether institutional investors are playing their part in promoting effective governance.

Government policy has favoured encouraging individuals to make personal provision for their future financial security and to reduce their reliance on the state. However, lack of public confidence in the investment system, and the means testing of benefits, have contributed to a reluctance to save amongst private individuals. Ultimately this could increase the long-term burden on the state.

Government and employers have an important role to play in encouraging individuals to save for their future. On the government's part, options range from compulsion to the use of tax incentives. A more acceptable approach than compulsion may be achieved through incentives to employers.

Our main proposals are that:

- * The major political parties should clearly set out their long-term approach to means testing and the treatment of savers, so that individuals are able to commit to long-term financial decisions with greater confidence.*
- * Additional fiscal incentives for savings and pensions should be considered in order to reduce dependency on state pensions – and to encourage long-term saving. An example might be to tax all gains as income within the early years of investment, operating a reduced tax rate for a period thereafter, diminishing to a zero tax rate – i.e. short-term gains treated as income, long-term gains tax free.*
- * Companies should be provided with incentives to contribute to stakeholder plans on behalf of employees.*
- * Further flexibility for savers and pensioners should be permitted, enabling them to save and to take the benefits of pension saving, at a time suitable to their individual requirements.*

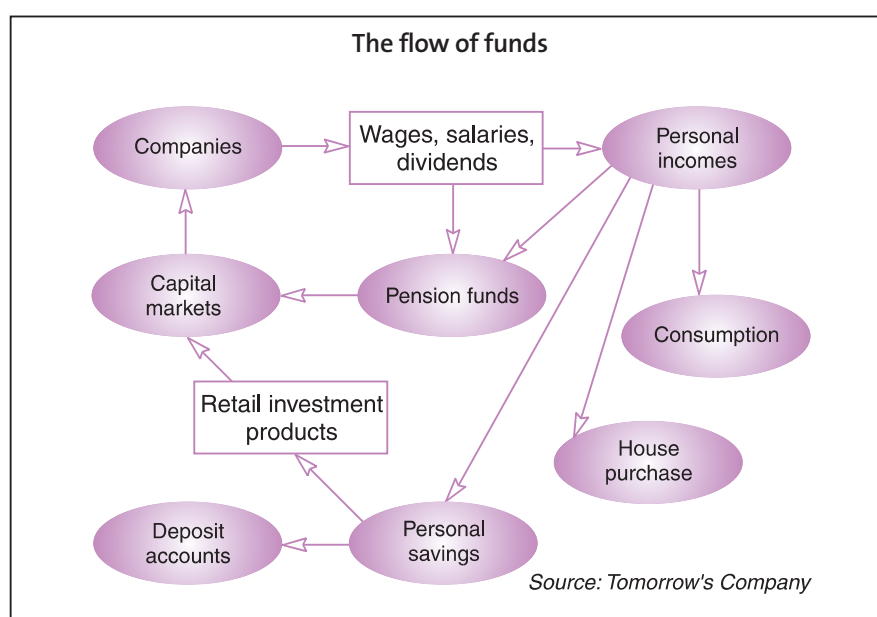
Restoring trust in a better investment system – a call to action

The UK needs a more effective investment system. To achieve the improvements we have described will require collaborative action on the part of the key institutions in the financial services industry, the major quoted companies and by government and the Financial Services Authority.

The next steps should involve more of the leading figures in the financial services industry coming together, tasked initially with responsibility for: drafting an overarching 'statement of principles' and standards for the industry; considering how the 'seal of approval' and accompanying sanctions might operate; drawing up a blueprint for the membership, aims and operating principles of the forum.

We are confident that the leadership exists to bring this about.

Twenty-first century investment: the inquiry



Aim of the inquiry

The aim has been to examine the effectiveness of the UK investment system and to put forward proposals designed to improve its contribution to the creation of sustainable value for companies, investors and the health of the UK economy and society as a whole.

The inquiry approach

This inquiry has involved a great deal of research but it has not been simply a research project – it has also about stimulating debate and building the engagement of all parties to achieve action and change.

The inquiry has spanned every link in the investment chain and involved leaders of all the communities who form part of the system, as well as representatives of government, the Financial Services Authority (FSA), trade associations, the financial media and other key influencers.

It has been shaped and led by an Inquiry Team made up of leaders in the financial and corporate spheres and supported by a Research Faculty comprising representatives from organisations that have lent their support.

I'd like to see all stakeholders – government, industry, consultants, fund managers and workers – come together to rethink the basic model. ... My pious wish is that we have the humility to recognise our past errors and the wisdom to find a better way forward.

*Alan Brown,
State Street Global Advisors.¹*

The inquiry has conducted:

- * Fifteen specialist consultative workshops with representatives from key groups across the investment decision making chain – including pension fund trustees, investment consultants and actuaries, fund managers, analysts and brokers, investee companies, venture capitalists and private equity and individual investors.
- * A public call for evidence.
- * Two workshops involving representatives from each part of the decision-making chain.
- * A private consultation stage amongst a number of key individuals, associations and other influential parties.
- * An Investment Summit at which the Inquiry Team’s initial findings were presented and which involved a number of interactive workshops where options of change were discussed in more detail.

In total, in excess of 500 people have been consulted.

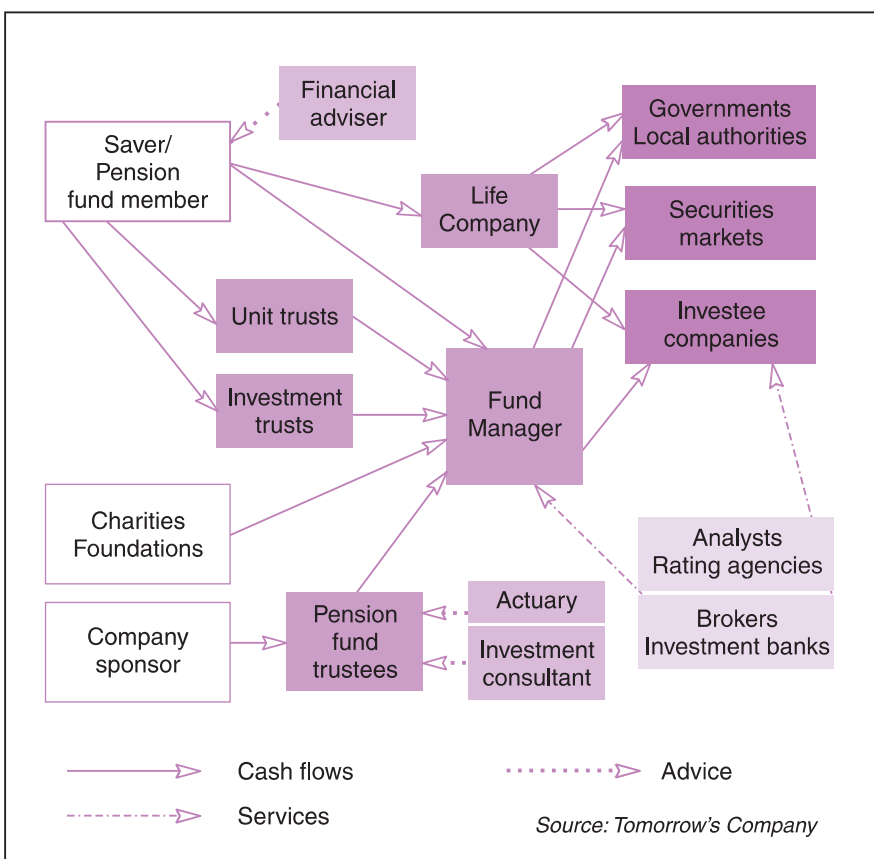
The investment system

The relationships between the various parties in the system create a complex matrix of interdependencies and interfaces.

The following diagram highlights the primary flows of capital, sources of advice and services across the system. In practice, the system and its relationships are even more complex. Conflicts of interest are endemic. Ownership of assets is separated from control.

‘In practice, the system and its relationships are even more complex.’

The investment chain



'It is important to be clear about the objectives, motives and interests of the various participants'

Evaluating the system

It is important to be clear about the objectives, motives and interests of the various categories of participants: individual investors, members and trustees of pension funds, the different intermediaries and fiduciaries, companies (both as investees and as sponsors of pension funds), trade associations, consumer bodies, the FSA and government.

For the purposes of the inquiry we have developed a set of criteria against which the system has been evaluated:

From the perspective of the individual investors

- * Are investors adequately assisted in clarifying their investment objectives and understanding their changing needs over time?*
- * Are they adequately advised in relation to the risks attached to various asset classes?*
- * Are adequate returns available for the risks they wish to take?*
- * Does the promotion of retail products create realistic expectations?*
- * How able are fund managers to deliver added value to their investors?*
- * Are there sufficient opportunities available to those who wish to take specific investment considerations into account e.g. ethical and environmental?*

From the perspective of the pension fund trustees

The above issues also apply in the case of pension fund trustees. In addition, the following are important:

- * Is the standard of actuarial and investment advice adequate to meet the challenges posed by changing market conditions?*
- * How meaningful and relevant are the benchmarks and performance measurements being used?*
- * Is the current regulatory framework appropriate and conducive to effective decision making?*

From the perspective of companies as wealth creators and sponsors of pension funds

- * To what extent are companies' interests adversely affected by short-term trading in the markets?*
- * How may long-term shareholders contribute to the effective running of the business?*
- * How good is the knowledge and understanding about the long-term performance of a company and the factors, tangible and intangible, which drive that performance?*

From the perspective of the health of the economy as a whole

In addition to the fundamental contribution of investment to economic growth, the main criteria are:

- * *Is there an adequate supply of capital available at economic cost?*
- * *Are innovation, entrepreneurship and risk taking encouraged?*
- * *Is the reputation of the financial community in the global financial markets, and hence the contribution to UK invisible earnings, being supported?*

Thinking about the system as a whole

Systems thinking has been used in order to consider the investment system as a whole. Focusing on the individual parts can result in a failure to appreciate the inter-relationships between the component parts of any system.

A 'quick fix' to solve one issue can have unforeseen implications elsewhere. Ignoring the dynamics of a system can trigger the chain reaction of blame and denial and may explain why many initiatives and much regulation to date have failed to achieve their desired outcomes and have often created unintended consequences.

Decisions to invest or seek capital are not made in isolation. They are reliant on other players in the market, the behaviour of which can be highly influential on different groups.

The approach adopted by the inquiry has therefore helped to identify a number of vicious circles in the current system.

'Focusing on the individual parts can result in a failure to appreciate the inter-relationships'

Someone else – the competitors, the press, the changing mood of the marketplace, the government – did it to us...Systems thinking shows us that there is no outside; that you and the cause of your problems are part of a single system. The cure lies in your relationship with your 'enemy'.

Peter Senge.²

The context of the inquiry

'...within a context of ongoing change, the impact of which on the system has been profound.'

As well as increasing in size, the UK population is now also older overall than it was in 1951. While the proportion of the population aged under 16 has decreased to 20 per cent from 24 per cent on census day 1951, the proportion of the population aged 60 and over has increased to 21 per cent from 16 per cent on census day 1951. Thus, for the first time ever there are more people aged over 60 than there are children. This ageing of the population reflects longer life expectancy due to improvements in living standards and health care. It also reflects the fact that there have not been any events with a corresponding effect on life expectancy like that of the first and second world wars.¹

The ratio of pensioners to people of working age is expected to rise from 1:4 now to 1:3 in 2025 and 1:2.5 in 2050. The rise for the EU as a whole is even steeper, from 1:4 now to 1:2.7 in 2025 and 1:1.8 in 2050.²

Nothing stands still...

The inquiry has taken place within a context of considerable ongoing change, the impact of which on the system has been profound. The most significant of these changes are summarised below:

- * *demographic trends*
- * *the economic background*
- * *the impact of technology*
- * *the corporate environment*
- * *the underpinning role of government*
- * *the influence of the European Union*
- * *the influence of the United States*
- * *structure of the capital markets*
- * *financing investment*
- * *the investment climate*
- * *culture.*

Demographic trends

Two main issues have become the focus of attention:

- * *the steady albeit gradual increase in life expectancy which has added to the liabilities of pension funds*
- * *the ageing population which is at least in part due to a fall in the birth rate following the post-war 'baby boom'.*

These two issues combined give rise to concerns about the ability of society in future years to afford the burden of an increasingly high proportion of dependants.

Economic background

There are concerns about the robustness of the current health of the UK economy. However, at the time of writing it is viewed with guarded optimism:

- * *There is a buoyant service sector, providing growing employment opportunities despite the development of offshore outsourcing. Retail banks have announced moves to transfer a significant number of jobs overseas – one estimate suggests that in the region of 200,000 jobs may go to India over the next five years.*

- * *Much of the UK manufacturing industry remains relatively depressed and faces the problem of an unfavourable dollar exchange rate.*
- * *Consumer debt is considered excessive and is rising.*
- * *Government borrowing has been rising.*
- * *The danger of deflation has recently receded, but a collapse in house prices is still feared.*
- * *Interest rates are at historically low levels but are expected to increase in the near future.*
- * *The UK has the highest level of employment in Europe.*
- * *The last ten years has been a period of relative stability in the economic environment.*

Impact of technology

Technological change has had a substantial impact:

- * *There has been a dramatic growth in electronic trading of shares fuelled by the availability of real-time information.*
- * *The ability to obtain comparative information about products on-line and the ease and speed at which it is possible to switch between providers has lessened investor apathy, especially for basic products such as banking and credit cards.*
- * *Customer service interface and levels of service have been enhanced through on-line provision of services available for extended hours – many being available 24 hours 7 days a week.*
- * *There is the potential for better communication between companies, investors and analysts through on-line provision of information and tools such as web-casts and web-site areas for investor comment.*
- * *The use of IT outsourcing in the front, middle and back office areas is high on the agenda. Investment banks have been slower to adopt this strategy but maintaining legacy systems is a growing expense, particularly in an increasingly competitive environment, and non-core functions such as administration are now being outsourced. However there are concerns about the need to develop effective interfaces with remaining functions, the capacity of the providers and sustainability of service levels as demand increases.*

The corporate environment

Business leaders face growing pressures:

- * *The global marketplace is increasingly competitive – this includes the search for top executive talent.*
- * *Shareholders and their representatives have become more vocal in their demands – shareholder activism has been stimulated to a large extent by a sense of disenfranchisement, perceptions of ‘rewards for failure’ and perceived corporate governance failures.*
- * *Other stakeholders have also become more active – for example non-governmental organisations (NGOs) and other pressure groups calling for greater corporate social responsibility. This has led to:*
 - *stricter guidelines in relation to corporate governance*
 - *the growth of socially responsible investment (SRI)*
 - *calls for wider reporting criteria by companies.*

- * *Demands for intervention and regulation have increased – further influenced by the impact of European, US and other international reforms such as more stringent accounting standards, Sarbanes-Oxley³, Basel II⁴, International Financial Reporting Standards (IFRS) etc.*
- * *The burden of the pension liability has worsened – becoming a central financing issue on many corporate agendas as they face significant deficits forcing them to review the future basis of their provision, and leading to the closure of many defined benefit schemes.*

The underpinning role of government

Pensions

Regulation and legislation on pension funds has markedly increased, despite repeated calls for simplification. Recent additions to the regulatory burden include:

- * *A new Pensions Bill was published on 12th February 2004.*
- * *Pension trustees have been given the power to wind up schemes.*
- * *An ‘insurance fund’ for pensions is to be created.*
- * *Basic ‘stakeholder’ pensions are being promoted.*
- * *The abolition of the minimum funding requirement (MFR) is to be followed by the introduction of scheme specific funding targets.*
- * *A new pensions regulator with considerably increased powers is to be established.*
- * *The cost of complying with new regulatory requirements continues to rise as interventions from regulators increase.*
- * *An increasing move away from state provision of pensions.*
- * *The Inland Revenue review proposing major simplification of tax rules concerning pensions. The proposals included replacing complex rules with an annual limit of 100 per cent of earnings and a £1.4 million lifetime limit.⁶*

Almost half the consultative papers issued by the FSA in 2002 were prompted by legislative developments or policy decisions by the EU or UK government.⁵

Government scrutiny and inquiry

There has been a whole series of reviews and reports, including:

- * *The Myners Review of Institutional Investment.⁷*
- * *The Sandler Review of Medium and Long-term Retail Investment.⁸*
- * *A simpler way to better pensions. An independent report by Alan Pickering.⁹*
- * *Report of the Equitable Life Inquiry.¹⁰*
- * *Independent Pensions Commission.¹¹*
- * *Report of the Coordinating Group on Audit and Accounting.¹²*
- * *Treasury Select and Trade and Industry Committees on:*
 - *split capital investment trusts*
 - *restoring confidence in long term savings – including endowment mortgages*
 - *transparency of credit card charges*
 - *directors’ contracts, performance and severance payments.*

Some of these reviews are summarised in Appendix 1.

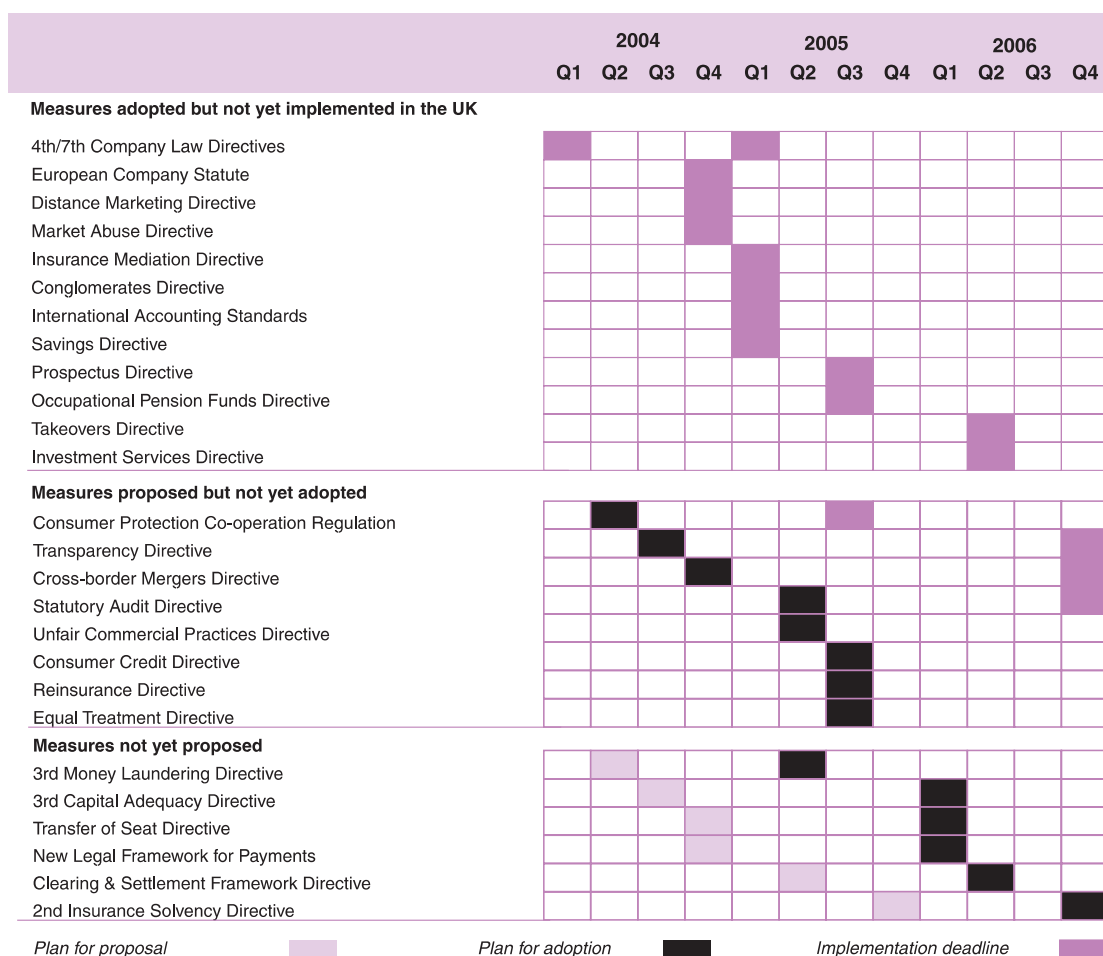
The influence of the European Union

The removal of barriers within the European Union, global de-regulation, new technology and the launch of the Euro have helped financial markets to grow and to become more efficient.

A Single Market in financial services has long been an EU objective. To achieve this objective by 2005, the financial services industry faces the task of implementing a stream of new measures as a result of The Financial Services Action Plan (FSAP) – designed to fill gaps and remove the remaining barriers to a single market in financial services across the EU. The UK financial sector, corporate sector and consumer groups will all be affected by FSAP measures, as and when they are implemented and the changes in EU legislation will effectively determine UK law.

The chart below shows the expected timeline for the main FSAP directives.¹³

Expected timeline for FSAP and other EU measures affecting the financial sector, 2004-06



Source: Based on information available at 30 April 2004

The EU also presented an Action Plan on Modernising Company Law and Enhancing Corporate Governance in the EU in May 2003. This focuses on strengthening shareholders' rights, reinforcing protection for employees and creditors and increasing the efficiency and competitiveness of business.

The influence of the United States

Given the global nature of investment and the dominance of the US it is not surprising that the investment system in the UK is subject to influence from across the Atlantic. In recent times the main developments have been:

- * *the well known cases of corporate fraud such as Enron and WorldCom and the associated collapse of Arthur Andersen.*
- * *dubious practices such as market timing in mutual funds and the abuse of investment research for sales purposes.*
- * *the fact that the US authorities have prosecuted individuals as well as fined companies*
- * *the litigious climate and its implications in particular for non-executive directors.*
- * *the tightening of the US regulatory system – for example the Sarbanes-Oxley Act.*

The overall impact of these events has been, on the one hand to contribute to the undermining of public trust in business and in financial services and on the other to encourage changes in the UK, both on the part of the regulator and within the financial services industry with the aim of avoiding similar problems arising.

Structure of the capital markets

The whole structure of capital markets is fundamentally changing:

- * *The arrival and increase in the use of hedge funds, derivative products, exchange traded funds, credit default swaps and traded options means that a vast number of transactions conducted on the market are not necessarily a reflection of the long-term performance of the investee companies.*
- * *Private equity is a growing outlet for capital and provides a further vehicle for investment which is not subject to the corporate governance requirements of a public company.*
- * *Pension fund trustees have been beginning to make cautious use of derivatives and hedge funds as they shift emphasis from relative performance to absolute return. This is further stimulating the growth of specialist funds, managers of managers and funds of funds.*
- * *The use of index tracking funds as the core part of an investment strategy and customised benchmarks that are market related has increased. (Appendix 2 discusses why indexation may not be a wholly positive development.)*
- * *The complexity of the investment system has increased, blurring the roles and relationships of different agents in the decision-making chain. One example is the move by investment consultants into the fund management field by providing manager of manager services.*
- * *Hard choices will need to be made by the owners of fund management companies; many firms are likely to be sold as the rate of consolidation continues or managers will need to change their business models radically.*
- * *Entry barriers have been reduced in many marketplaces as the need for physical infrastructure is lessened fuelling innovation and competition in such areas as on-line banking and share trading.*

‘The whole structure of capital markets is fundamentally changing’

‘Hard choices will need to be made by the owners of fund management companies’

Table 1 below lists the top ten asset managers in the world, ranked by the value of assets managed. Although the UK is a major financial centre, overseas firms dominate asset management globally and only one of the top ten is UK-owned.

Former leading UK financial services companies – such as SG Warburg, Kleinwort Benson and Mercury Asset Management – were acquired by overseas firms such as UBS, Dresdner Bank (now itself taken over by Allianz AG) and Merrill Lynch. Such acquisitions have often led to the integration of investment banking, broking and fund management within a single organisation, so the table also sets out a selection of the other activities that the parent group is involved in.

**Table 1: Global assets of top ten asset management groups
(ranked by assets under management at 31 December 2002 ¹⁴)**

Asset Manager	Country	Total assets managed (US\$bn)	Other group activities include
UBS	Switzerland	1468.1	Investment banking, stockbroking, custody services, fund of funds
Allianz Group	Germany	1037.0	Investment banking, stockbroking, life assurance
Fidelity Investments	US	910.5	Custody services and pension fund record-keeping/actuarial services
Credit Suisse	Switzerland	861.5	Investment banking, stockbroking
Deutsche Bank	Germany	804.5	Investment banking, stockbroking
Kampo ¹⁵	Japan	802.5	Life assurance and protection
AXA Group	France	773.0	Life assurance and protection
State Street Global	US	762.9	Custody services, performance measurement
Barclays Global Investors	UK	745.5	Investment banking, fund of funds, credit cards, mortgages
Vanguard Group	US	584.9	None

Financing investment

For a company to generate wealth over the long term, it needs to have access to capital at an appropriate cost.

Table 2 summarises how UK companies have financed their investment requirements. Managers displayed a strong preference for using internal funds and then bank finance, such that new equity and bond issues were a positive source of funds only toward the end of the twenty five year period studied.

Table 2: UK Net Sources of Finance (%)¹⁶

Source	1970-74	1975-79	1980-84	1985-89	1990-94	1970-94
Internal	76.3	101.5	106.4	82.6	74.2	86.1
Debt	22.9	5.5	13.3	39.3	5.9	17.4
of which:						
bank finance	20.4	6.7	11.4	30.3	0.2	13.5
bonds	2.6	-1.3	1.8	9.0	5.8	3.9
New Equity	-5.7	-3.3	-7.0	-20.8	11.3	-4.2
Other	6.5	-3.7	-12.6	-1.1	8.5	0.7

More recent research confirms the general preference for funding through retained earnings, but also finds that the means of funding major spikes of investment changes as company size falls. Larger companies supplement their retained earnings by issuing debt, while many small companies (who may be growing and not earning profits) raise funds through new equity issuance.¹⁷

The role of the capital markets, therefore, seems to shift as companies grow. For the larger companies, bond markets and syndicated finance are available, so the role of the stock market becomes that of an indicator of corporate health and a test of the credibility of a management. Smaller companies, however, may have less freedom to act. Their activities may be too small to justify a bond issue, so they have a greater need to use the equity market as a source of finance.

The investment climate

The consequences of the long bull market which ended at the start of this century and its subsequent collapse are many and far reaching.

‘The consequences of the long bull market which ended at the start of this century and its subsequent collapse are many and far reaching.’

Unrealistic expectations

Some investors still expect unrealistically high levels of returns.

The long bull market conditioned many, both private individuals and pension fund trustees, to believe that double digit returns were an achievable norm. Reputations and fortunes were made with relatively little effort and the financial services industry did nothing to persuade people to moderate their expectations. Index tracker funds became regarded as a safe investment, and fund management companies competed for savers’ money by promising to outdo their peers in active management.

Furthermore, chief executives of quoted companies, feeling pressure from investors for double digit earnings, felt they had to try to achieve these rather than challenge unrealistic expectations.

Pension fund sponsors, whose funding of schemes was based on the premise that returns and inflation would be higher than turned out to be the case, found themselves facing funding deficits exacerbated by the already serious problem of increased life expectancy. All these factors have led to the closure of many defined benefit schemes and a shift of the risk from company to employee as defined contribution schemes were set up in their place.

Loss of faith in equities

There has been a move away from equities into bonds and cash as trustees and insurance companies sought a better matching of liabilities and individual savers sought less volatile investments.

Advisers have renewed their focus on dividend streams and cash flows following the realisation that the earlier paper gains had been just that.

Many individuals by now have lost sight of the proposition offered by the equity market and many underestimated the risk involved.

During the bear market from March 2001 into March 2003 many investors moved away from equities. Whilst there has been some market recovery, the question arises as to whether confidence will be fully restored. Many private investors have increasingly diversified their portfolios into property and bonds as have the remaining defined benefit pension schemes. Other forces, such as FRS17 and pension regulation, have further encouraged investment in asset classes other than equities.¹⁸

Culture

Corporate culture

The best chief executives combine managing the future with managing the present. They recognise the need to keep the confidence of markets, but do not allow the pressure of those markets to deflect them from laying the foundations for long-term value creation.

'The best chief executives combine managing the future with managing the present.'

There are, however, a number of pressures particularly upon publicly quoted companies which, taken together, have contributed to a change of atmosphere. The result is that, in practice, it becomes harder for chief executives to achieve this balancing act. The pressures include the following:

- * *The importance attributed by markets to hitting precise earnings targets.*
- * *The raised expectations about earnings growth targets, often as much as 15% earnings growth.*
- * *The growing importance of short-term share price performance in determining total remuneration.*
- * *The shorter horizon over which chief executives feel the markets will judge them as a success or failure.*
- * *The average tenure of chief executives is shortening.*

By the late 1990s, CEOs were subject to greater pressure than at any time in history, being hostage to the short-term gyrations of the share price and subject to attack for any shortfall of performance against the analysts' expectations. In effect, corporate governance and shareholder value had been turned into a stylised, even ritualistic game in which all quoted companies were required to show faultless and perpetual growth in earnings... Any shortfall of earnings against analysts' expectations was and is ruthlessly punished by a savage fall in the share price.

John Plender.¹⁹

'Leaders manage portfolios, not people.'

Leadership – the old ways are untenable; equally new ways are daunting; senior executives and investment professionals need far more innovative thinking, emotional resilience and personal rapport than ever before.

CREATE and KPMG.²²

Many of these pressures are not directly imposed by the markets. Frequently they are experienced by companies because that is what they believe the markets require.

These pressures on companies and their boards can all too often lead to related pressures on employees and the development of a blame culture when very demanding targets are not achieved. In this kind of atmosphere bad news gets suppressed and there is an outflow of some of the most able people.

The problem is particularly acute in instances where the roles of chairman and chief executive have been combined and a highly autocratic style of management has prevailed.

When targets are not achieved a frequently chosen path to future success is to change the chief executive, yet there is evidence to show that this course of action rarely results in improved performance.²⁰

Culture in investment management

A report by CREATE and KPMG drew on the observations of managers in the fund management industry and suggested that at both company and individual level they perceived a leadership vacuum and a lack of direction.²¹

The 'self portrait' of the industry that emerges from the research is one of a culture characterised by star performers, inflated egos, a lack of loyalty to both client and employer and a blame culture. Leaders manage portfolios, not people.

However the report also notes signs of positive change:

- * *top teams beginning to work like teams*
- * *existing leaders' skills being developed*
- * *more team working in the front office*
- * *paying people on a mix of individual and team performance*
- * *adopting matrix structures to increase integration.*

Our conclusions

This inquiry has met and consulted key players in the investment chain that links the saver at one end with companies at the other.

An impression conveyed by some parts of the media is that the whole system is fatally flawed or irreparably broken, with advisers and fund managers failing to help savers and institutions starving UK industry and commerce of the capital that is its lifeblood.

The general conclusions reached by the Inquiry paint a less gloomy picture:

** The system is relatively robust:*

- *despite concerns about the increasing burden, the UK regulatory system is praised in other countries*
- *there are reform initiatives coming from the various parts of the system and there is a good stream of product innovation to reflect changing market conditions and the diverse needs of investors.*

Equally there are some problems which lie outside the industry's control:

** There has been a fundamental change in the investment world as a result of falling inflation and low interest rates and this has led to some severe problems, particularly in relation to endowment policies and their use to repay mortgages.*

** Increases in life expectancy are creating funding problems in the pensions field.*

In this environment, there may be a temptation to believe that 'the market is king' and no player can do anything to affect the way it works. However, there are some blockages and distortions that need to be addressed and significant improvements can be achieved if the various key players in the industry do take responsibility, and not just for their individual roles in their markets, but also in terms of working together and taking joint action.

'The system is relatively robust.'

The UK's large and sophisticated financial sector features fundamentally sound and highly developed financial institutions, markets and infrastructure, supported by a financial stability policy framework that has been significantly strengthened in a number of ways in recent years, and that in many respects is at the forefront internationally. The UK is: "developing a very advanced, indeed leading edge, approach to financial sector supervision".

International Monetary Fund. March 2003. ¹

'...there are some blockages and distortions that need to be addressed'

The key issue - a crisis of confidence and lack of trust...

'Trust in the integrity of the financial services industry has been eroding.'

Recent developments have damaged the image of market-based financing in the eyes of issuers, investors and policy-makers. They have highlighted the propensity for herd-like behaviour on the part of capital market participants. They have demonstrated that market professionals can also be swept away by euphoria. The 50% decrease in market valuation since March 2000 means that retail equity investors have had their fingers extremely badly burnt. The prospect of European retail equity culture has been dealt a severe blow.

*Dr Alexander Shaub,
DG Internal Market²*

62% of British adults do not trust business leaders.³

'The gap between those who own and those who manage companies has grown.'

Trust in business is badly dented, a situation exacerbated by Enron and other scandals. This pervading mistrust is, Digby Jones believes, the single biggest challenge facing British business today. "In a British context we – that is, business and politicians – have to get the message across that the scandals which contributed to this situation are not British issues; Enron was an American problem, Parmalat is an Italian problem. We must make sure people understand that our corporate governance is probably the best in the world."⁴

In Financial Services

Trust in the integrity of the financial services industry has been eroding. A series of misselling scandals and the behaviour of sell side analysts are amongst the activities that have served to undermine the level of trust in the integrity of the financial services industry. These are not accidents of history. They are systemic. In particular they flow from lack of transparency, lack of alignment between the interests of investors and those of intermediaries and the failure to manage endemic conflicts of interest.

At the same time, confidence in the competence of the industry has been severely damaged by herd-like behaviour shown in the period leading up to the collapse of the bull market. The benefit of active fund management has also been questioned given that justification for the higher fees charged is not always evident in terms of outperformance compared with passive funds. (Appendix 3 discusses reasons why this may be.) Given the impact of the three year bear run on peoples' savings and pensions it is only natural that their advisers and fund managers become the natural targets for blame.

The investment industry has experienced severe criticism for its lack of transparency in regard to conflicts of interest, and for practices such as soft commissions, lax corporate governance, and poor absolute performance. Concerns have been also been raised about the level of earnings within the City institutions, particularly in periods of falling returns, and questions have been asked as to whether they apply to themselves the same rigorous standards they demand of quoted companies. The lack of trust and transparency has been intensified by a failure on the part of the various links in the chain to communicate and work together effectively in the interests of the end investor.

Companies

The lack of trust also extends to the perception of the major corporates. Many of their actions have served to erode the relationship with employees and society which in turn has a long-term impact on productivity levels.

The gap between those who own and those who manage companies has grown and the transference of powers to management has been criticised by some as having led to excessive corporate behaviour.

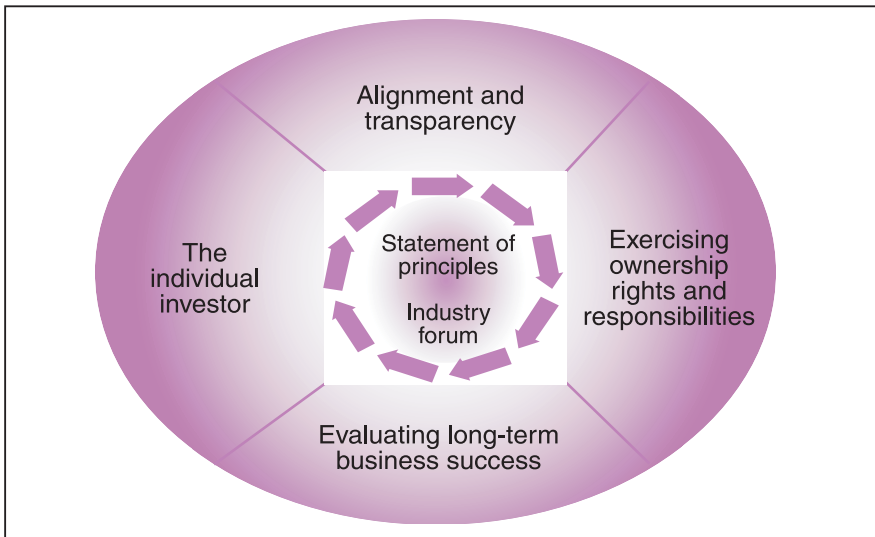
There have been some highly publicised business failures related to fraud or incompetence, with recent examples including Marconi, Enron and Parmalat.

There is continuing concern about levels of executive compensation seemingly unrelated to performance.

Employees have lost trust in some companies as they are not only closing defined benefit schemes but also cutting contribution levels to defined contribution schemes at the same time as increasing executive remuneration packages.

Foundations

The inquiry has taken a systemic approach to examining the effectiveness of the whole investment system in terms of the value it delivers to investors and to investee companies. Not surprisingly, therefore, the key areas identified for change are interdependent:



** 'Integrity', 'trust' and 'confidence' are the foundations for the healthy functioning of any good productive long-term relationship, of which integrity is the key. There has been a loss of confidence and trust in the financial service system and re-building and maintaining these foundations is now of vital importance. This requires the industry to speak with a single voice on issues that affect its reputation. At the heart of the proposals, therefore, is the creation of an industry-wide forum for self-regulation. This will provide an arena where the leaders of the whole investment system can come together on a regular basis to address this imperative and to develop, as a matter of urgency, an overarching 'statement of high-level principles' to cover all aspects of the industry and to which all parties can sign up. This statement in conjunction with the forum will rebuild trust through proactive assessment of practices and products against these principles and standards and demonstrate that the industry is prepared and willing to act before others force it to do so either through increased regulation or litigation. The combination of the proposed forum and 'statement of principles' can also act as a framework to facilitate moving forward the other specific proposals for change and against which these changes can be assessed to ensure overall fit and cohesion.*

** In addition to the principles, there needs to be greater alignment and transparency throughout the system – clarity at the outset of every contract, transparency at every stage and for objectives, timescales and incentives to be aligned so as to meet the expectations and needs of the investor, thereby increasing accountability and facilitating the effective monitoring of performance.*

'Integrity', 'trust' and 'confidence' are the foundations...'

'...the industry needs to speak with a single voice on issues that affect its reputation.'

- * One of the critical areas for alignment that needs to be considered in more detail is the way in which institutional investors exercise the responsibilities and rights of ownership that are delegated to them by the ultimate investors.*
- * Long-term investors are looking for long-term durable performance. It is important therefore that those who invest on their behalf have a deep understanding of all the factors that drive this. There is an imbalance between financial and non-financial measurement, and between short-term and long-term measurement, which needs to be addressed so that investors ask the right questions and companies have the right information to answer them.*
- * Finally, an effective market place depends on the presence of well-informed and empowered individual investors who know their needs and are better prepared for obtaining advice so that any meeting with an adviser is on more equal terms. This condition is not yet met, and there is a long-term challenge to increase the financial literacy and risk awareness of individuals. At the same time there is a requirement for access to relatively inexpensive, objective advice and greater protection from misselling.*

These proposals can be summed up under five headings, each of which is developed in more detail in the next chapters:

- * The need for clear, enforceable standards and principles.*
- * Alignment and transparency.*
- * Exercising ownership rights and responsibilities.*
- * Evaluating long-term business success.*
- * The individual investor.*

The inquiry team's vision

Trust has to be restored: investor trust in financial services products and their providers; in companies and their boards of directors; the trust of pension fund trustees in their advisers and fund managers.

'Trust has to be restored...'

An investment system is envisaged where:

- * strong investment performance is pursued over the long term by a focus on good business standards*
- * long-term investors (shareowners) and short-term dealers (shareholders) both have a place in a balanced market*
- * business is conducted transparently in order to promote trust and confidence*
- * long-term profitability is achieved by linking targets and incentives to the needs of investors*
- * investors and companies take the obligations of ownership seriously through ongoing dialogue*
- * customers are offered clear choices and have access to the necessary information to be in a position to choose.*

The realisation of this vision depends upon the concerted action of a group of individuals and organisations who together span all the links in the investment system and who have it within their remit to remove obstacles for change and create a climate of confidence and trust.

This is not just a call for action by others. It is a commitment to action by the signatories to this report, and an appeal to others to take responsibility for action.

Changing the investment system – the way forward

'Markets are the best way to allocate resources...'

Every individual necessarily labours to render the annual revenue of the society as great as he can. He generally neither intends to promote the public interest, nor knows how much he is promoting it...He intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for society that it was no part of his intention. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it.

Adam Smith.¹

Introduction

Markets are the best way to allocate resources and enable individuals, enterprises and societies to make rational choices.

However, as Adam Smith made clear in his writings, a firm social foundation is required before the 'invisible hand' of market forces can work efficiently. For example, property rights must be strong, and there must be widespread adherence to moral norms, such as prohibitions against theft and misrepresentation.

This tradition of economic freedom, underpinned by a sense of shared values and social limits, has developed further in the UK over the last two decades. In the United States the emphasis has been on the freedom of business to do whatever it likes provided it complies with the letter of the law. If business steps over the socially acceptable line, the response has been the heavy hand of the law, as in the case of Sarbanes-Oxley.

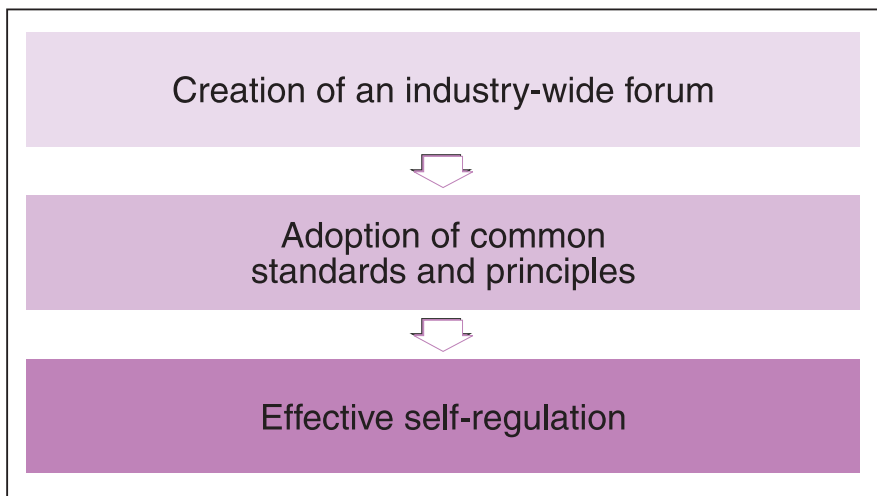
The UK, by contrast, has evolved a tradition of business-led codes, based on the 'comply or explain' principle. When a problem arises, whether it is to do with executive pay, or the effectiveness of boards, there is a widespread belief, which is shared both by leaders of business and government policymakers, that it is better to deal with it in a way that is light on regulatory compulsion, and strong on transparency and accountability.

The underlying assumption is that compliance with law and regulation is not an end in itself, but a means of securing the trustworthy operation of markets. This is the spirit behind the proposals that follow. They are designed to reinforce the efficient working of the capital markets and to minimise the extent to which blockages, conflicts of interest and other distortions operate against the interests of investors.

In formulating the proposals the members of the Inquiry Team have taken account of a number of initiatives that are already under way. In accord with the vision set out earlier, we do not envisage the full range of our proposals will be acted on in the short term. They are framed with a view to bringing about radical change over the next decade or so – change which we believe to be essential to the survival and development of a flourishing UK investment system.

‘...bringing about radical change over the next decade or so ...’

Most of the proposals are intended for action by the relevant practitioners within the financial services industry rather than calling for further regulation or legislation. They can be summarised as operating at three levels:



Key Area for Change 1 - the need for clear, enforceable standards and principles

Why this is required

A basis of trust

Confidence and trust are the foundations for the healthy functioning of any good productive relationship. They can be easy and quick to destroy, yet very difficult to restore. Restoring them usually takes considerable time.

Without these basics in place other efforts to bring about change may be futile.

Elaborate measures to ensure that people keep agreements and do not betray trust must, in the end, be backed by trust. At some point we just have to trust. There is, I think, no complete answer to the old question; 'who will guard the guardians?' On the contrary, trust is needed precisely because all guarantees are incomplete. Guarantees are useless unless they lead to a trusted source...

Since trust has to be placed without guarantees it is inevitably sometimes misplaced; others let us down and we let others down. When this happens, trust and relationships based on trust are both damaged. Trust, it is constantly observed, is hard earned and easily dissipated. It is valuable social capital and not to be squandered. *Baroness O'Neill.*¹

As Paul Myners has pointed out, a company's values and beliefs hold it together more than its structures and systems. The words 'openness', 'transparency' and 'accountability' appear at the heart of discussions concerning corporate governance. However, although important, they have been emphasised to the exclusion of other principles without which the concepts of openness and transparency have little value. These more fundamental principles are 'integrity', 'trust' and 'confidence' of which integrity is the key. It is these three principles that lie at the heart of any process of stating and implementing standards of conduct.

Why this applies to the financial services industry

The financial services companies operating in the London markets enjoy an unrivalled reputation globally not only for being well regulated but also for observing high standards of integrity. This reputation is a priceless asset, the benefits of which are enjoyed by all the various types of institution that make up the UK financial services industry.

Q. A loss of trust in the industry is a big concern right now. How can trust be built up again?

A. I think as an industry, by us having one absolute standard for integrity and zero tolerance for any movements away from integrity.

*John Fraser,
Global Chairman and CEO, UBS Global Asset
Management*²

'...a company's values and beliefs hold it together more than its structures and systems.'

'This reputation is a priceless asset.'

The City of London alone accounts for 14.0% of London's GDP and an estimated 2.6% of the UK total. There are more corporate headquarters located in London than in any other European city. Financial services' net exports reached a record £17.8bn in 2002. Overall, net exports have risen more than three-fold over the past ten years from £4.9bn in 1992.

*IFSL November 2003.*³

There can be no doubt, however, that trust in the UK financial services industry has been eroding over a number of years as a result of well-documented scandals, failures and shortcomings.

Loss of trust in any one area is a negative factor for the whole industry – whether in equities and corporate bonds as secure investments, in fund managers and life companies as stewards of one’s savings or pension fund, in banks as fair dealers, in analysts and the objectivity and validity of their research, in brokers and their handling of conflicts of interest, in investment banks and their role in acquisitions and mergers or in actuaries and consultants in terms of the validity of their advice. In consequence people are discouraged from saving for the long-term. They may see investing in residential property as a surer route to financial security, or they may just settle for ‘living for today’ – the new car, the second holiday.

Erosion of trust is a problem that the industry as a whole needs to face together. An important first step in the process of restoring trust is for all parties to recognise and acknowledge the erosion of trust that has taken place.

There is a stark choice – more and more costly regulation, more and more bureaucratic interference, or the industry acting collectively to put its house in order. It is imperative that collective action be taken to preserve the industry’s reputation. This is the basis of the argument for an overarching statement of principles and a collective, industry-wide process of implementation.

Why we need another set of principles

The industry is not lacking in codes of principles and standards of conduct.

There are many, some of which are listed below:

- * *Association of British Insurers (ABI) – Raising Standards Quality Mark Scheme*
- * *Association for Investment Management and Research (AIMR) – Code of Ethics and Professional Code of Ethics and Standards of Professional Conduct*
- * *British Bankers Association (BBA) – Banking and Business Banking Codes*
- * *Financial Reporting Council (FRC) – The Combined Code on Corporate Governance*
- * *Financial Services Authority (FSA) – FSA Handbook*
- * *Institutional Shareholders’ Committee (ISC) – Responsibilities of Institutional Shareholders and Agents – Statement of Principles.*
- * *Investment Management Association (IMA) – Code of Good Practice Institutional Investors and Corporate Governance by Association of Unit and Investment Trusts and Investment Funds (AUTIF)*
- * *The Myners Principles for effective management of a pension fund*
- * *National Association of Pension Funds (NAPF) – Corporate Governance Policy (containing the Statement of Underlying Principles).*

and the list goes on.

Each of these deals with some aspects of the behaviour of the industry but none can be called ‘joined-up’ or overarching principles. Moreover, they are quite variable in scope.

‘Loss of trust in any one area is a negative factor for the whole industry.’

There is an increasing overlap and interaction between banks and securities markets, and between both of them and the insurance sector. A problem in one can have a knock-on impact in the others. Most of these organisations are prudentially supervised by the FSA. But there are also organisations that are not supervised but which could be of systemic importance.

*Sir Andrew Large,
Deputy Governor for Financial Stability, Bank of England.⁴*

‘There is a stark choice...’

Unquestionably financial stability is a critical ingredient in a high performing market economy... any definition would surely refer to the crucial roles of confidence, resilience and reliable liquidity... The starting point for this confidence is the players in the market place. It relies on integrity in individual firms and markets, effective standards and high quality prudential controls and risk management practices.

*Sir Andrew Large,
Deputy Governor for Financial Stability,
Bank of England.⁵*

A serious gripe of business leaders is the recent proliferation of corporate governance codes – to which they are supposed to adhere – from bodies ranging from the Financial Reporting Council to the National Association of Pension Funds. Sir Nigel Rudd, chairman of Pilkington and Pendragon, came armed with a pile of the various codes. “Which one of these shall I comply with?” Sir Nigel asked investors.

Sundeep Tucker.⁶

‘There is a need for high-level principles...’

In a survey conducted by PricewaterhouseCoopers and the Economist Intelligence Unit in 2002, managers at over 40 financial services groups around the world responded, and an overwhelming majority of 60 % agreed that “Trust has been eroded and will only return when institutions themselves change the way they are run and report results”.⁷

The FSA has constructed a framework of principles, supported by more detailed rules and guidance, and developed a risk-based approach to regulation. We do not seek compliance for its own sake. In any case, mechanical compliance has done little to prevent problems in the past, often with serious repercussions for those affected. The principles – our high level standards – are based on ethical values. But it is not clear that this ethos is fully understood or applied consistently by everyone working in the industry. The financial services sector is quick to seize on recent episodes at Enron and Allied Irish Bank and condemn them out of hand. But the public perception of most financial firms as interested in making money at the expense of all other considerations seems to be unchanging.

The sector undoubtedly feels the pressure. Take our new regulatory regime as an example - with a long and detailed Handbook. This highlights perfectly the crux of the issue. Surely, if the sector conducted its business in line with the overall standards and principles in the higher level sections of the Handbook, the progressive regulatory restriction felt by many would be avoided. However, some parts of the sector seem to be at the stage where the question is more likely to be “show me where it says we can’t ...?” rather than “how can we improve our standards and conduct our business with integrity...?” *Professor David Jackman. Business Ethics Adviser, FSA.*¹⁰

The FSA principles, which *are* designed to apply to the industry as a whole, are no substitute for a set of principles created for the industry by the industry.

These separate initiatives are not enough.

The industry needs to speak with a single voice on issues that affect its reputation. There is a need for high-level principles that cover all aspects of the industry and to which all parties can sign up. There is also a need for investors both to be fully aware of what the code promises and to be able to place their trust in that commitment.

A brief history of one initiative:

In 1992 the NAPF Performance Monitoring Group – now the UK Investment Performance Committee (UKIPC) – published the Pension Fund Investment Performance Codes. This was a voluntary standard, originally confined to the performance track records of balanced UK pension funds and was updated in 1996 to include segregated accounts. The UKIPC played a prominent role in developing AIMR’s Global Investment Performance Standards (GIPS) and came up with their own version, UKIPS, which were recognised by the Investment Performance Council, the body responsible for GIPS as a country version of GIPS in the autumn of 2001. Although many of the big players have become GIPS compliant because they recognise its value as a passport or kite-mark for doing global business there is still plenty of resistance to the sort of transparent market that GIPS seek to encourage.

Referring to the Global Investment Performance Standards, David Gamble, chief executive of BA Pension Investment Management and Chairman of the UK Investment Performance Committee said “These standards are good news for investors, offering better transparency and a level playing field. I’d advise trustees to think carefully before hiring a manager that isn’t GIPS compliant, or is at least planning on being so.”⁸

The majority of UK based fund managers (70.3%) are GIPS compliant. 29.7% of fund managers are currently non-compliant and more than half of these (63.6%) are actively seeking compliance. According to the Spaulding 2002 survey, 50% of UK based money managers said that they were in compliance with GIPS, and 56% said that they were in compliance with UKIPS.⁹

Regulation by the FSA, which is about complying with rules, and which remorselessly grows more complex as product innovation takes place (and as some organisations seek loopholes in the existing regulations), cannot of itself provide the answer. Rule-based regulation can promote action aimed at meeting targets and being seen to comply, but emphasises minimum standards at the expense of trying to achieve best practice. It can also lead to unintended consequences. The FSA plays a more constructive role when it assists and monitors processes of self-regulation, which are standards or principles based and for which the industry itself assumes responsibility.

In 2003 Roger Steare conducted a survey of ethical practice within 15 of the UK’s largest financial services firms. The firms had a combined value of over £200bn, and employed over 600,000 people. He found that 73% publish business principles. But most

- do not clearly articulate their business principles
- do not recognise that everyone in the firm is responsible for ethical standards
- do not recognise the ethical standard or integrity of recruits – at any level, including the board
- do not have effective ethical learning and development programmes
- do not recognise ethical dilemmas or handle them with integrity

“It is arguable that most of these firms are in breach of the FSA’s high level principles for businesses. My writing personally to each of the chairmen concerned led to only two responses, both of which declined the invitation for discussion” *Roger Steare.*¹¹

Agenda for Change

Our proposals

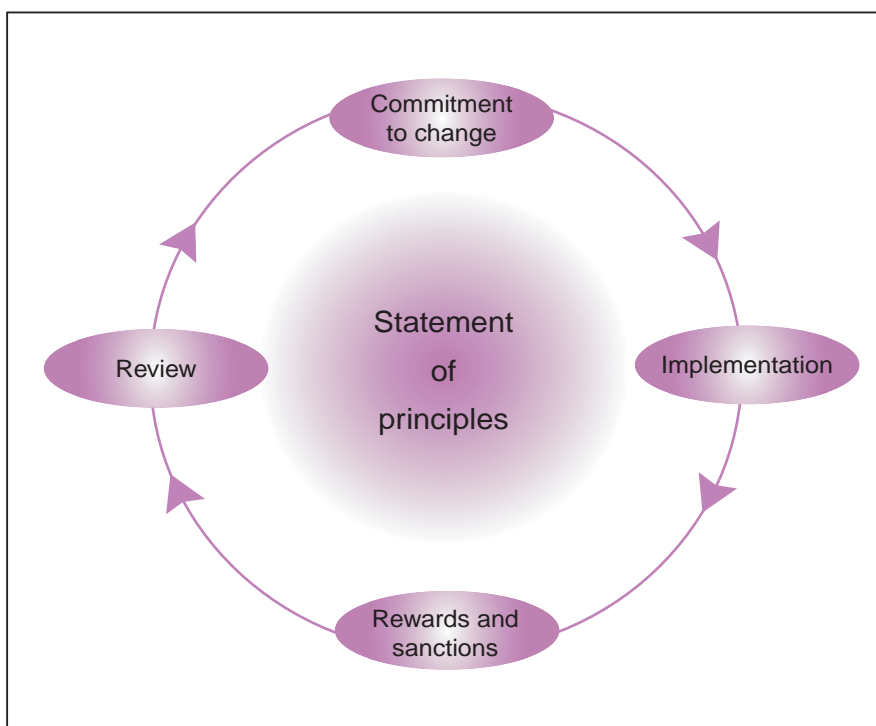
We propose the development of an overarching code for the financial services industry, which is clear and simple and encompasses high-level principles and standards that can be easily understood by investors.

At the same time this should stimulate:

- * *the many existing bodies for each specialist part of the industry to satisfy themselves that their own existing codes and principles are adequate and that adherence to them is effectively monitored*
- * *financial services providers to ensure their internal procedures, such as product development, meet with these overarching standards.*

Establishing the standards and principles

To make the statement of principles come alive, there will, in our opinion, be at least four steps. The process will also involve action at three distinct levels – the financial services industry as a whole, the various trade associations and specific disciplines within it and at the level of the individual company.



Values form the basis of trust. When they are left unstated, they are inferred from observable behaviour. When they are stated but not followed, trust is broken. Hence the usefulness of codes of ethics. But principles/values contained in such codes must be real, credible and embedded in the fabric of the company – in its systems, processes, practices and rewards, not just in its annual report or on wallet cards carried by the company's officers. In the same way that successful corporations are defined by values which form the basis of trust, our major investing institutions, the insurance companies, pension funds and those who manage their assets, must also have defining values that justify our trust, inspire our confidence and meet our requirement for integrity.

*Paul Myners.*¹²

'...at least four steps.'

Step 1 - Commitment to change

The financial services industry as a whole

Ultimately the investment system depends upon the confidence and trust of the public it is designed to serve. The whole industry will need to make a commitment to the effect that it exists to pursue long-term profitability through observing the highest standards of integrity and seeking continual improvement in its standards of service.

'...observing the highest standards of integrity and seeking continual improvement...'

The creation of a forum for self-regulation

We are therefore proposing the creation of a forum for self-regulation which would be representative of the whole UK financial services industry. It would provide an arena where the leaders of the whole investment system could come together on a regular basis to:

- * *provide a multi-disciplinary forum for debate and discussion with the aim of increasing understanding of each other's perspectives, sharing concerns and developing solutions*
- * *develop the proposed statement of principles which would then support the establishment of an industry-wide 'seal of approval'*
- * *encourage the development of, or review of existing, standards and principles for the specific disciplines and interests within the system*
- * *invite their stakeholders to make constructive comments and criticisms from which lessons could be learned, and steps taken to improve performance*
- * *publicly demonstrate that they and their colleagues were taking practical steps to implement the behaviours that their statements of principles advocated*
- * *gain competitive benefit though adoption of the seal of approval and put in place appropriate sanctions.*

The membership of the forum would include investor and company representation and work alongside the FSA in ensuring, as far as possible, compliance with a set of principles or standards for the conduct of business which would be monitored and enforced by the industry but with enforcement by the FSA as a fall back.

Even if the industry as a whole does not take up this challenge straightaway, we believe there is value in some of the leaders of the industry making a start and setting an example. The establishment of this forum would be seen as an act of collective leadership. The industry would be strengthened, and problems identified much earlier than at present.

'The establishment of this forum would be seen as an act of collective leadership.'

A useful example on which to draw is the formation of the National House Builders Registration Council.

The National House Builders Registration Council (NHBC), the forerunner of today's National House Building Council, (NHBC) was set up in 1936 to counter jerry-building. The organisation has evolved over the past 68 years to become an industry leader, setting standards and providing consumer protection on new homes throughout the UK.

The 1960s, with its building boom, proved to be a definitive period of change for NHBC. In that year, the ten year Buildmark protection was introduced. The scheme won further approval when the Building Society movement backed it. Between 1963 and 1969 the total number of registered builders rose from an estimated 1,700 to 14,000 – accounting for over 90 per cent of private house builders.

In recent years NHBC has worked to raise standards in new home construction and provide consumer protection. A strategic review, begun in 1997, brought in many initiatives: a new 'consumer committee'; increases in Buildmark cover; an improved Resolution service; a new Land Quality Standard; builders' guidelines on customer care and finishing standards; a video and guide to explain the Buildmark to home buyers; a training video for builders' sales staff; and an NHBC website. To date NHBC has provided cover through its 10 year Buildmark warranty and insurance scheme to over 6m home buyers. It also provides a comprehensive range of services to its 18,000 registered builders which aim to achieve its central goal of raising standards in the UK house-building industry.¹³

Without a momentum for change from the leaders of the industry, trust will not be restored and the initiative for change will have been surrendered to regulators.

'Without a momentum for change...the initiative for change will have been surrendered to regulators.'

At trade association/specific discipline level

The various trade associations and professional bodies, which represent specific disciplines and interests within the financial services industry, would play their part both in the proposed forum and developing or reviewing their own standards and principles to ensure fit with the overarching statement.

At individual company level

Commitment cannot be achieved without strong leadership supported by shared values and a supportive culture.

'Commitment cannot be achieved without strong leadership.'

Managements of most large businesses recognise the importance of values and they articulate their values in codes of conduct. But how many of them seek to embed their values and the ethical behaviour that should flow from them into their culture? How many seek to do this consistently across all their operations world-wide? How many simply produce their code of conduct, send it to their employees, stick it on the corporate website and say job well done?

The most important part of the implementation process is the example and leadership given by senior management. Directors and Managers who walk the talk and demonstrate their integrity. Managers who are not afraid to talk about values. They can talk about values in business performance terms: values as a source of competitive advantage; values that underpin corporate reputation and reinforce risk management; values that are part of the intangible assets of the business. *Ken Rushton. Project Director, Listing Review. IBE, Director of the UK Listing Authority.*¹⁴

There may be good intentions at the top of a company and carefully prepared statements of principles, but if employees do not feel that their livelihoods depend on upholding these principles then little change will be achieved through the organisation.

But even transparency and accountability are not enough to establish public trust. In the end, both depend on people of integrity. Rules, regulations, laws, concepts, structures, processes, best practices, and the most progressive use of technology cannot ensure transparency and accountability. This can only come about when individuals of integrity are trying to “do the right thing,” not what is expedient or even necessarily what is permissible. What matters in the end are the actions of people, not simply their words.

*PricewaterhouseCoopers.*¹⁵

Step 2 – Implementation

At trade association/specific discipline level

The alignment between the overarching statement of principles and those of the associations and professional bodies will create the framework for action to be taken at this level. This may require an account of the member organisation’s stewardship with regard to the principles as part of the membership renewal process.

Accordingly, where the behaviour of a member organisation or individual is found to be inconsistent with the principles they are likely, by default, to have breached the association’s or professional body’s own principles. A range of sanctions would therefore be applicable from disciplinary action through to expulsion. (In some cases the latter may need a change in the rules of an association.)

Individual company level

The translation of fine words into actions can only take place at the level of the enterprise, but it starts right at the top, where boards of directors must set the example. Chief executives should be invited to make a personal statement setting out what their corporate principles mean to them, how they intend applying them in their management of the business and how those who breach the principles will be dealt with.

Top management’s commitment to a set of principles must be reflected in the actions and behaviour of employees at all levels. This can be achieved in a number of ways:

- * *Education about the principles and reference to their importance to company reputation and business success in employee induction programmes.*
- * *Incorporating assessment of compliance with the principles in performance appraisal systems.*
- * *Where remuneration includes a discretionary or bonus element, a significant part of that element is related to compliance with the principles. This is particularly important in the case of marketing and sales personnel.*
- * *Exemplary disciplinary action in the case of individual breaches of the principles.*
- * *Providing an account of the organisation’s stewardship with regard to the principles as part of the annual reporting process.*
- * *Non-executive directors would have an important role to play in monitoring the implementation process and the standard and integrity of marketing related to products.*
- * *Perhaps most importantly, members of senior management acting as role models.*

Evidence of such action should form an important part of the process of awarding the proposed industry-wide ‘seal of approval’.

Step 3 – Benefits and sanctions

On the positive side the development of an industry-wide ‘seal of approval’ to support the statement of principles could provide a visible and marketable endorsement, similar to that of the National House Builders Registration system. Another to consider might be the Association of British Travel Agents.

In time this may also encourage others to support the overall initiative. This would lead in due course to a significant competitive advantage for those organisations which meet the criteria for award of the seal of approval and a celebration of outstanding commitment to its values.

I mentioned the Institutional Shareholders’ Committee, relaunched last October. I support this initiative but have reservations about the extent to which it is fully and unequivocally supported in practice by institutional investors. I have come across a number of CEOs and CIOs of investment managers who profess little or no knowledge of the ISC. This I believe to be a symptom of a worrying dichotomy within fund managers – the Head of Governance is presented to the corporate community as the fund management group’s voice on governance but lacks any seniority within his or her own employer and frequently speaks and acts without the support and knowledge of the relevant portfolio manager and the fund management group’s leadership. This is unacceptable. The role of the fund manager in governance cannot be discharged by a disempowered corporate busybody. The leaders of our major investment management institutions need to rise to the challenge and become more visible in governance matters – they have, for instance, to date largely stood aside from the debate on Higgs. Higgs will only deliver the goods if fund managers play their part. *Paul Myners.*¹⁷

In cases where organisations were clearly in breach of the principles the sanction would be the withdrawal of the ‘seal of approval’.

Step 4 – Constant Review

The progress of the whole system in taking us forward in earning customer trust will need to be regularly reviewed. The proposed industry-wide forum also provides the arena where this kind of regular assessment of progress can take place – effectively an annual general meeting for the whole savings, wealth creation and investment process. The FSA and associations would play a vital role in this process.

In a more stable environment, companies will be able to pay more attention to developing a cohesive corporate culture, and to building a corporate ethic. Or are more providers going to realise that trust is a competitive advantage? .

*Richard Lambert.*¹⁶

How the statement of principles and the existence of the industry-wide forum would make a difference in practice

We have highlighted that there are already numerous sets of codes and principles in place developed and supported by various bodies and associations. With little additional expense it should be possible to achieve collaboration across these existing structures to develop the proposed 'statement of principles' and 'seal of approval'. Much of the detailed implementation, as we have outlined, will need to take place at the level of trade association, specific discipline or individual company.

The proposed new forum would not have the resources to enable it to examine the validity of each new investment product before it was launched in the market (just as the National House Builders Council does not scrutinise the plans and specifications for every housing estate). However, just as the existence of the NHBC kite-mark has greatly reduced the incidence of jerry-building, so the equivalent in financial services could help to diminish the incidence of misselling, biased research, misleading advice or other inappropriate activity reducing the need for further regulation or legislation.

If an effective industry-wide forum were in place, blatantly inappropriate activity might be identified, challenged and thwarted at an early stage and long before regulatory intervention resulted in penalties for those involved. Investors may have little understanding of the downside risk of many investment products but a clear set of industry principles, properly applied, would result in fewer such products either being introduced or promoted to inappropriate audiences with insufficient clarity.

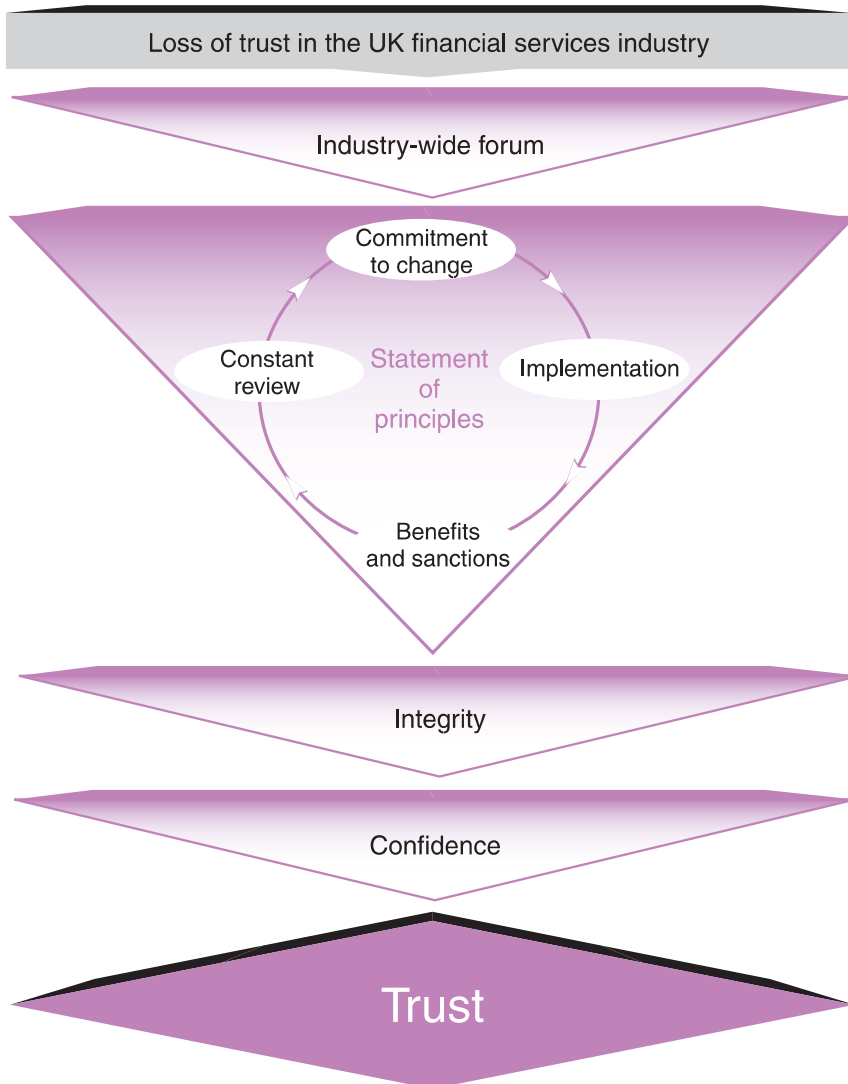
Proactive testing of new products against industry principles could help to avoid the adverse impact of fines and compensation as well as the harm inflicted on both the company's and industry's reputation.

Overall, the fines and compensation, compliance cost and most importantly the mistrust could be reduced if the whole industry took such a proactive approach.

'...fines and compensation, compliance cost and most importantly the mistrust could be reduced...'

Trust and integrity – the need for clear, enforceable standards and principles

Putting it all together



Key Area for Change 2 - alignment and transparency

Protecting the status quo is no longer a viable option. In order for things to change - and change they must - there has to be a real sense of constructive engagement and dialogue throughout the industry.

*Barry Marshall,
COO, Investment Division, Gartmore.¹*

'The value chain that links savers to institutional investors and companies...needs to undergo a revolution'

Introduction

The principles of alignment and transparency should apply across the system. All parties in the investment value chain need to share the responsibility of protecting savers from conflicts of interest.

The car industry in the UK came under the influence of the Japanese manufacturers such as Toyota and Honda as a result of the pressures of global competition. The result was a revolution in supply chain relationships. It was no longer enough for the car manufacturer to be content with maximising profits at the expense of component suppliers. The game changed so that the car manufacturer formed long-term relationships with component suppliers and others in the value chain to drive out cost and improve quality.²

These long-term relationships were founded on trust. Suppliers and internal customers learned to create a shared culture of continuous improvement. Their combined focus became the enhancement of value not the extraction of the maximum short-term profit from the next link in the chain. Shop floor employees learned tools and techniques to do with problem solving, elimination of waste, statistical process control. Rewards went to those who delivered the highest product quality and rendered outstanding customer service.

The value chain that links savers to institutional investors and companies in the UK needs to undergo a revolution of a similar kind. If it does not do so, there will be a continued erosion of trust and lost confidence.

What we mean by 'alignment'

By alignment we mean the degree of fit between the objectives of investors, the various intermediaries in the investment chain and investee companies.

Agents and fiduciaries are more likely to act in the best interests of their clients if their objectives are aligned with those of investors, investee companies and intermediaries. (They are legally required to do this, but past experience indicates that enforcing the law in this area can be a problem.) The performance incentives that apply to agents (organisations as well as individuals) should encourage them to act in their clients' interests.

Also where conflicts of interest might arise they should be clearly identified and either eliminated or handled in a way acceptable to the client.

What we mean by ‘transparency’

It needs to be apparent to investors how the resources they have entrusted to their agents are being managed; who is getting paid for what performance; whether bonuses have been justly earned; how much value is eroded through transaction costs and fees to advisers and the cost of regulation.

Achieving better alignment – the issues

1. Pension funds - investment objectives

If agents’ actions are to be aligned to the objectives of clients it follows that those objectives must be framed in a clear and realistic way.

‘...objectives must be framed in a clear and realistic way.’

The Statement of Investment Principles

In the case of pension funds the starting point for the alignment of objectives of all parties to the contract is the Statement of Investment Principles (SIP), setting out the investment philosophy and strategic framework for the management of a pension fund. Once the actuarial assessment of the liabilities has been made, the philosophy set out in the SIP is then carried through into the construction of the mandates awarded to fund managers to execute that strategy.

The Myners Review highlighted the need for Statements of Investment Principles to be strengthened so that members might gain access to better quality information as a matter of course and set out ten principles for defined benefit schemes.^{3&4} A requirement to produce a SIP and to review it at regular intervals is included in the current Pensions Bill.⁵

Construction of the mandates

Actuarial assessments

The design of a mandate begins with the actuarial assessment of the pension fund’s liabilities. There has been some criticism of the actuarial profession’s performance in this respect in recent years.⁶ The Myners Review also discussed actuarial performance and recommended that pension fund trustees should be encouraged to obtain actuarial advice and investment advice from different sources.

Specifying the terms of the mandate

Given an objective assessment of the liabilities to be met, the aims of a pension scheme need to be translated into an investment strategy designed to meet its liabilities at an appropriate level of risk. The factors that influence alignment are:

- * *the time horizon over which the matching is to be achieved*
- * *a scheme-specific benchmark for performance measurement purposes*
- * *a statement of the fund’s policy with regard to responsible investment*
- * *the specification of the basis for determining fund managers’ fees.*

The big problem concerns the valuation of pension liabilities. Antiquarian actuaries use a discount rate that takes credit for expected future equity returns, while second-guessing whether equities are undervalued. This is crazy - and not just because actuaries are fallible in judging markets. They take credit for equity outperformance while failing to allow for risk, which amounts to double counting.
John Plender.⁷

Commenting on the winning entry, Peter Moon, USS's Chief Investment Officer said: "The fundamental purpose of the competition was to stimulate new thinking and innovation in the pension fund industry and there is no doubt that this has been achieved. The breadth and diversity of entries from both corporates and individuals was very encouraging and provides a great foundation for deepening and broadening the debate about what responsible long-term investors really need from our service providers."⁸

The ideal mandate

An example of what is considered to be a model mandate is in Appendix 4. This is the winning corporate entry in a competition sponsored by the Universities Superannuation Scheme (USS) and Hewitt Bacon & Woodrow in 2003. The basis of the competition was a hypothetical mandate to be awarded to the company, team or individual who best convinced the judges that they will deliver long term outperformance and do so in a genuinely responsible manner. In the instructions for the competition, entrants were asked to consider how they could help the imaginary consortium of pension funds meet its members' need for absolute returns over the long-term and simultaneously encourage responsible globalisation and business behaviour so that 'pensioners and their children would experience a better quality of life in the future'.

The competition sought to stimulate investment professionals to think about how to deliver returns which matched real needs without undermining the quality of life for pension fund members when they came to retire. The questions posed were: What type of mandate should we be setting? How should material, social, environmental and governance issues be taken into consideration? How should we monitor, assess and reward fund managers?

Lack of alignment

Evidence from our consultation workshops suggests that in the past two years there has been considerable progress on the part of pension fund trustees in moving towards the model outlined by the Myners Review. Appendix 5 provides a summary of progress to date.

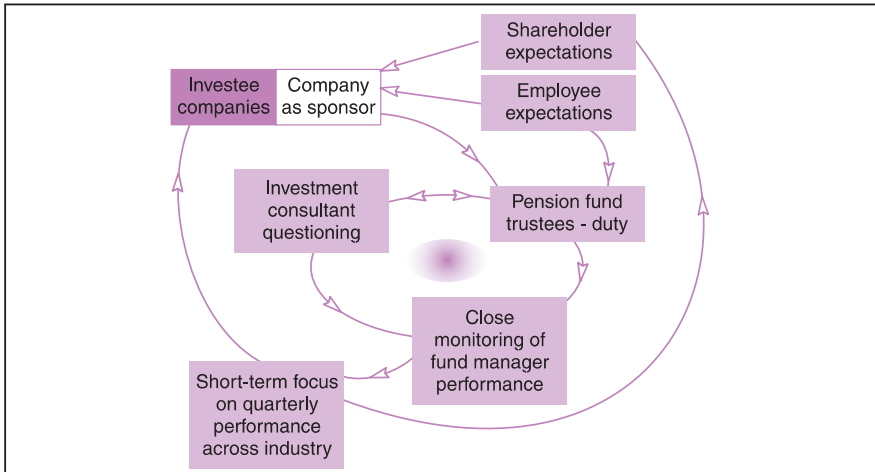
Equally, however, there are indications that the other parties in the investment process are not yet fully aligned to this approach.

Lack of alignment can occur if:

- * *Pension fund trustees are unduly influenced by the short-term performance of fund managers.*
- * *Investment consultants are influenced by the fees involved in organising 'beauty parades'.*
- * *Fund managers or company management pursue short-term objectives.*
- * *Fund managers focus on performance relative to that of their peers.*
- * *Fund managers attach greater importance to the risk of losing a mandate than the risk to trustees of failing to match liabilities.*

Short-termism

One major cause of potential misalignment between the objectives of the investor and those of the agents is caused by a mismatch in time horizons. Pension scheme trustees and others are often criticised for their short-term objectives in investing the assets under their control.



Pension provision is essentially a long term process, yet short-termism arises from a vicious circle of expectations:

- * *Employee expectations built up in past years have left companies faced with huge pension liabilities.*
- * *Employers place pressure on trustees to ensure they are monitoring the fund closely as they want to eliminate fund deficits and keep contributions to the minimum.*
- * *Trustees through their fiduciary duty are responsible for the performance of the fund and for any loss. They therefore tend to monitor the performance of the fund closely whenever they meet – usually on a quarterly basis.*
- * *Trustees may consider that they monitor on a light touch basis but fund managers may view this as pressure for short-term results.*
- * *Investment consultants to justify their intermediary role ask for more explanation and more numbers.*
- * *Fund managers place further short-term expectations on investee companies.*
- * *Companies are under pressure to eliminate fund deficits as quickly as possible ...and so it goes on.*

There are also external factors to which pension fund trustees feel they are obliged to respond:

- * **Accounting requirements** – and in particular the provisions of the accounting standard FRS17 impose pressures on trustees to seek shorter term returns to avoid pressures on the employer's balance sheet. Until the introduction of FRS17 employers and the trustees could take a more relaxed view of the rise and fall of the stock market. Such market volatility is less acceptable today, and because of the impact on the employer's balance sheet trustees are less able to take a longer term view of the performance of the portfolio in their custody.
- * **Solvency requirements** – pressure to restore funding levels to meet solvency requirements in as short a time frame as possible has driven trustees to focus on short-term performance and to accept inappropriate levels of investment risk.

* **Trust law** – especially more recent case law, has also driven trustees to seek short term performance. Pension funds in principle are the quintessential long term investor – however, the fiduciary obligations imposed in recent years to measure their performance on an increasingly frequent basis has encouraged them to look at it over shorter periods too. The Unilever case, which in the event was not decided in the courts, has had a marked effect on the method of trustee and manager guardianship e.g. trustees and their managers monitor and measure the effectiveness and the risk exposure of their portfolios in relation to their performance objectives more frequently. A board of trustees which supports the asset manager’s conviction that performance will emerge over time is potentially vulnerable to criticism from its members (especially in defined contribution schemes) resulting in possible claims for restitution.⁹

* **Actuarial valuation standards** – the change in actuarial valuation conventions in the last decade from a dividend-based to a market-value system has made it harder for trustees to take a longer-term view. Because of the actuarial volatility which now applies, trustees are no longer able to look at liabilities (as opposed to assets) on the basis they have done in the past.

2. Remuneration and incentives – the issues

The achievement of better alignment through processes of remuneration and incentives involves two aspects. The first is the need to reward fund managers and company directors at least partly based on genuine achievement of challenging yet realistic goals. The second is to ensure that bonuses and other performance-related rewards throughout the system are achieved following sustained performance over a reasonable timescale.

‘...incentives have become too short-term.’

Good compensation practices link pay and performance so that both shareholders and managers benefit, and so that the rewards to management bear a direct relationship to defined performance hurdles.

The principles of (i) aligning shareholder and executive interests and (ii) providing pay for performance have been used to justify massive grants of stock options to CEOs. However, all too often rewards pay lip service to these principles without being actually correlated to them. If pay awards genuinely linked shareholder and executive financial interests, and if pay awards were substantially correlated to value creating performance, there would be far fewer issues with compensation policies.

Richard C. Breeden. Corporate Monitor.¹⁰

Although there are moves towards extending timeframes, in general, incentives both in fund management and in the companies in which fund managers invest, have become too short-term.

There would be much better balance between the competing interests throughout the capital market system, including professional fund management, if incentives were constructed using a much longer time horizon. The pay structure should reflect sustained incremental growth in wealth creation with any incentive structure having built into it some form of escalation of reward based on cumulative added-value over the longer term. This means that the businesses which employ fund managers must also be prepared to commit to a longer term investment horizon in order to provide sufficient security of tenure and motivation of their key players to fit in with the longer time scale for the delivery of rewards.

Fund managers’ remuneration

Pay structures vary greatly from company to company. Some investment companies employ a ‘star manager’ approach. The rewards are potentially very high and may well include a significant element of performance-related pay. Depending on the company, share participation may be a possibility.

Other institutions adopt a ‘process-driven’ approach to investment and those businesses may prefer to emphasise the collegiate operation of their investment team. In such instances it is the team and the investment philosophy, rather than individuals, which count for most. In these structures, there is probably less scope for performance-related bonuses, but basic salaries may be greater, particularly for more senior people.

In the alternative funds world, the structures tend to be very different with substantial proportions of any gain in excess of an agreed threshold being claimed by the investment manager. It is argued that in this structure the interests of the investment manager are more closely aligned to those of the underlying investor. However, the counter argument is that the manager may be inclined to take unjustified risks, particularly if his or her performance-related bonus is at risk rather than his personal capital. For client and manager interests to be aligned, the manager would need to be a significant capital investor in the fund.

The question is whether or not the criteria which trigger performance-related recompense are sufficiently demanding and, conversely, whether adequate risk constraints are in place to protect the underlying investor against any regrettable outcome as the investment manager endeavours to trigger short-term rewards.

Remuneration of company directors/senior executives

Executive remuneration has become the subject of much debate and hostility over recent years. As a result it is now subject to far more intense scrutiny – by the ABI, the NAPF and other governance organisations and shareholder activists. There is now the requirement to submit remuneration to a vote at the AGM.

However, reward packages and increases in those packages are still often perceived to have become excessive and detached from the underlying performance of the company. Often this is a result of pressure on the recruitment market for scarce talent. Directors’ remuneration is not perceived to be aligned to the achievement of the company’s medium to long-term objectives and numerous guidelines have been issued to address ‘rewards for failure’.

It is important to think creatively about the design of compensation packages which relate reward to long-term performance.

Ultimately what is required is a change in culture amongst company boards – those awarding contracts to new executives will frequently be executives themselves and only a change in their outlook can truly remedy the problem of rewards for failure. We think that the means by which this change can best be brought about is through compliance with suitable standards of best practice. At present, therefore, we do not advocate legislation. If, however, the wishes of shareholders are not being adequately reflected in contracts being agreed by companies’ remuneration committees, or the contracts themselves are unable to be enforced, then the case for legislation will need to be reconsidered. *House of Commons Trade and Industry Committee.*¹¹

Achieving increased transparency – the issues

Clear objectives and transparency about charges, conflicts and remuneration are necessary conditions for the effective operation of any value chain.

Charges

Increased transparency about the basis for various charges will enable investors to assess how much added value brokers and fund managers actually deliver.

This is not a fresh issue in the fund management industry. I think it is inevitable that there is going to be pressure on what we call soft dollars or soft commissions... they won't go completely, but certainly there is a trend towards their elimination. What is more important is that fund managers will be forced, and quite rightly so, to clearly declare where they are being compensated on a soft commission basis. I talked earlier about transparency. The fund management industry has to clearly state what its revenues are, what fees are being charged to clients and, on a revenue side, what part of that includes soft commission and how that also affects the client.

*Bob Parker,
Deputy Chairman Credit Suisse Asset
Management.¹²*

The cost of running a fund – where does all the money go?

Until recently, fund performance measures have focused on the net returns generated by the underlying assets and the performance of the fund manager relative to a benchmark. Management fees have been declared, but limited regard has been given to all the costs incurred. The 2000-3 bear market provided the impetus for pension fund trustees and others to scrutinise the costs more carefully.

Most charge structures do not include significant fixed charges. Instead, charges tend to be related to the size of the assets managed, for example management fees. Typical charges incurred by a pension fund are around 0.3% p.a.¹³ while charges for retail funds are around 1.6-1.7% p.a.¹⁴

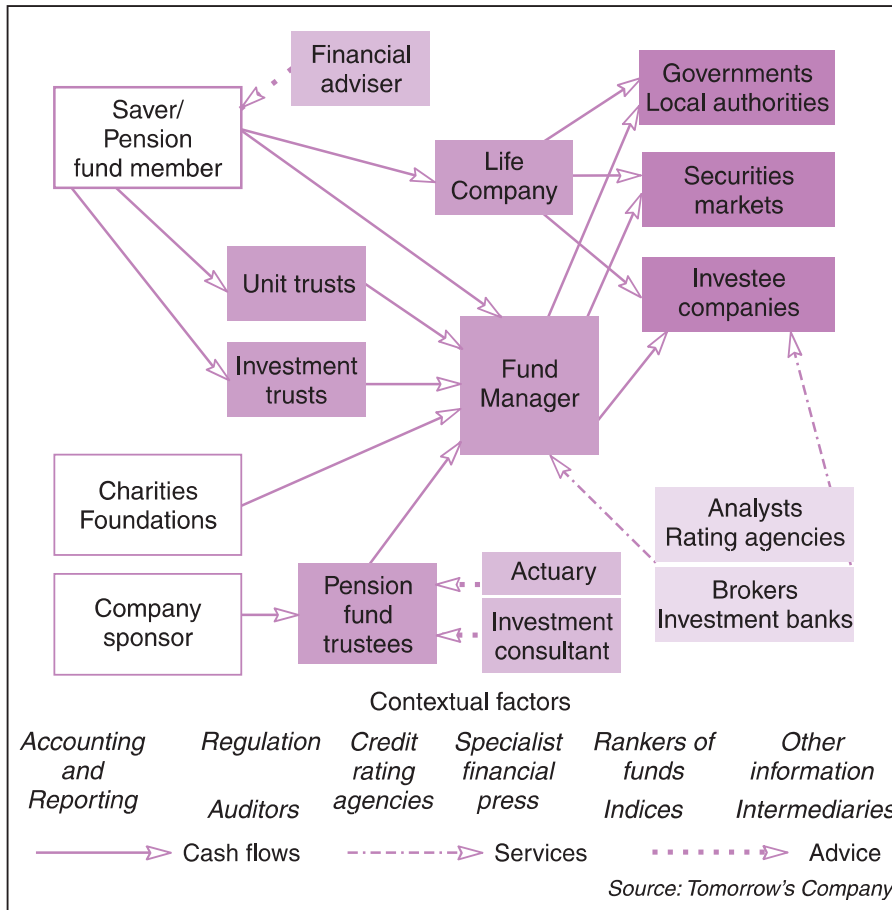
However, these charges are not the only costs incurred. Portfolio turnover incurs transaction costs that, including commissions and stamp duty, are estimated to cost 1-1.5% of the transaction's value.¹⁵ With the median fund turning over 55% of its portfolio each year¹⁶, ongoing transaction costs are likely to reduce the value of a fund by 0.5-0.8% p.a. Although commissions and stamp duty are explicitly recognised, the remainder of these costs are not visible as they are a part of the overall profit/loss figures on a fund's capital account.

In addition to the ongoing turnover of a portfolio, these costs will also bite when assets are transferred between fund managers. Differences in mandates or stock selection policies may mean that the changeover process involves trading in the market, rather than an off-market transfer of assets from the outgoing manager to the new one. The costs of such exercises may not be evident to the client.

Progress toward increasing transparency of charges is being made on a voluntary basis via a code of conduct drawn up by the IMA and the NAFI, introduced in July 2003. This aims to help pension fund trustees understand the costs and charges levied on pension funds and improve transparency by providing a clear and standardised reporting format.

Conflicts of interest

The investment chain



Potential conflicts of interest are an inherent feature of financial delegation processes. While transparency, disclosure and a competitive environment can go a long way in terms of restraining or avoiding conflicts of interest, certain features of the institutional asset management industry could potentially bias the decisions of ultimate investors. While recent debates on corporate governance issues have shifted attention to the incentive framework of, in particular, audit firms and research analysts, other important areas have so far been left out. This includes the incentive structures of players like investment consultants, index providers, rating agencies and fund managers' sales networks...Going forward, critical awareness of such potential conflicts of interest and their implications seems to be warranted.

Committee on the Global Financial System.¹⁷

All parties in the investment system have to deal with conflicts of interest:

- * Pension fund trustees who may also be directors or senior managers of the sponsoring company experience a conflict of interest between the financial health of the company and the funding level of a defined benefit scheme. In many cases that conflict has been eliminated as far as future service is concerned by closing the scheme. It remains however a real issue in the case of past service, particularly when there is a significant funding shortfall, given that the trustees have the power to call for the winding up of the scheme, with the potential consequence that the employer is forced into liquidation. This situation endorses the case for professional trustees.
- * All pension fund trustees potentially face a conflict between their duty to the interests of the scheme members and their concerns as individuals, to avoid being sued for failure to perform their duties adequately. This can distort their ability to assess risk and create a bias against the use of alternative asset classes.

'All parties in the investment system have to deal with conflicts of interest...'

- * *Project-based fee structures may give investment consultants an incentive to urge regular reviews of fund managers, which in turn may conflict with the long-term interests of a scheme. For consultants that offer 'manager of manager' services, additional questions arise about impartial advice and their objectivity in monitoring how well a fund is doing.*
- * *Fund managers face conflicts when they are researching the companies whose assets they manage or may seek to manage in the future, as well as concerns that a critical assessment may potentially sour the relationship with the client.*
- * *Once fund managers reach a certain size, the importance of client retention may be more of a business issue than winning new contracts. In these circumstances, the focus of the fund manager may shift from meeting the client needs to trying to ensure that its performance matches that of other funds.*
- * *External sources of research may be selected based on whether the charge for it might be wrapped up in brokerage fees or incurred separately.*
- * *The loyalty of auditors to the shareholders is a fundamental principle of the capital markets. Equally a considerable number of external parties need reliable financial statements to facilitate an effective marketplace. It is clear that the largest audit firms are professional services companies providing a wide variety of advisory services, despite the sale of large scale consulting operations which have been divested by most of these global auditors. The new legal and regulatory powers enforced by audit committees are bringing a much reduced relationship between audit and non audit fees but it is too early to quantify the effectiveness of this process; historically audit fees were often dwarfed by fees for other services. There is potential still for conflicts of interest to arise. Auditor independence has therefore come under scrutiny as never before and the pressures to run successful professional services businesses with audit as a key but not sole component need a very sure hand and considerable skill. (Initiatives to strengthen the quality of the audit function are discussed more fully in the section 'Evaluating long-term business success' on Page 83)*

Many of these conflicts have already been the subject of much debate and are in the process of being addressed. One that has received less widespread attention in the UK concerns investment banks.

Investment banks

These are frequently global organisations staffed by highly intelligent and resourceful individuals. Their operations have the power to impact every sector of industry and commerce.

Investment banks engage in a wide range of financial activities. Not only do they finance corporate activity – underwriting new bond, equity and convertible issues, and, in some instances, bank lending, they give advice both to the companies with plans to issue securities and to the investors with funds to purchase them. Of particular note is their ownership of fund management groups. The multiple use of capital in modern investment banking (i.e. the use in underwriting, securities market-making, corporate finance advisory, proprietary trading, commercial banking, etc.) would boost the return on capital in the absence of competition, but competition drives down margins and the return on capital. The reduction in margins has the result that the investment banks are very competitive against specialised, single-capital-use organisations (i.e. those which carry out only underwriting, or only securities market-making, or only stockbroking).

The investment banks therefore eradicate the single-capital-use organisations (the merchant banks, the jobbers, the brokers). This breadth in their operations creates conflicts of interest in a way that was not true with the single-capital-use organizations and which became more apparent in the 1990s.¹⁸

According to Professor Tim Congdon, in the bull market a deliberate aim of investment banks' corporate finance departments was to encourage merger and acquisition activity, benefiting not only from the advisory fees but also from all their underwriting and arrangement fees when securities had to be issued to pay for the deals. They ran their institutional securities trading on a break-even basis rather than to make profits and provided purportedly 'free' research. In short, equity trading and research were under-priced and over-supplied in order to promote acquisition and merger business, other corporate advisory work which paid high fees and, crucially, new equity issuance. So-called 'analysts' were persuaded by bonuses from corporate finance teams to write so-called 'research' on companies which might be about to do a good deal.¹⁹

Research findings in 1999 showed that 83% of mergers and takeovers made by large quoted companies had failed to produce any benefits and over half actually destroyed value.

By 2002, the picture had improved, but only marginally. About 30% of the deals examined created value while 70 % destroyed value or made no discernible difference.²¹ Growth for growth's sake via takeovers has been a prime cause of shareholder value destruction.

A February 2002 Survey by KPMG of the largest international takeovers consummated at the height of the bull market shows that a third are now being unwound. Businesses acquired at great cost are being disposed of for fractions of their acquisition costs. Since that report was compiled the evidence has become even stronger. The firms where the greatest, indeed almost total loss of shareholder value has occurred were serial acquirers of other companies – for instance Enron, Tyco, WorldCom - whose high stock market ratings required continuous acquisitions.²⁰

'Growth for growth's sake via takeovers has been a prime cause of shareholder value destruction.'

There is therefore routinely almost always a clear conflict of interest. The motivation of the corporate finance arms of investment banks in approaching a company with proposals for mergers and acquisitions is fees. The temptation for the management of the companies is the opportunity to exercise control over a much larger merged or restructured entity, with the accompanying increase in remuneration and the kudos that comes with running a larger company. There is a danger that this may sway their objectivity.

Evidence submitted to the inquiry by the Chartered Institute of Personnel and Development relating to the impact of mergers and acquisitions is contained in Appendix 6.²² The conclusion reached was that – although it could not be stated whether the situations they described are typical of all FTSE companies because the sample was not comprehensive – there was a remarkable consistency, enough to suggest strongly that in many companies:

** top management decision making about mergers and acquisitions is significantly influenced by the investment system*

** decisions are frequently not in the best interests of those who have an interest in the future performance of the business.*

Conflict of interest between the sales activity of brokers and the provision of investment research

A further potential for conflict exists in the tension between the investment banks' role as broker, using research as a sales tool for mergers and acquisitions, and their role as provider of independent research designed to inform the activities of their fund management clients.

Agenda for Change

To make the investment chain more effective and to uphold the proposed ‘statement of principles’, discussed in Key Area for Change 1, require clarity at the outset, transparency at every stage and for objectives and timescales to be aligned in order to meet the expectations and needs of the investor – whether short or long-term.

There needs to be a concerted effort, on the basis of deep and open relationships, to ensure that any conflicts of interest are effectively managed, and if not, ultimately removed.

Since incentives affect behaviour, it is also vital that the compensation of all parties is awarded in a way that achieves alignment and commitment to the objectives and timescales set out for the particular transaction.

‘...clarity at the outset, transparency at every stage and for objectives and timescales to be aligned...’

If I had a magic wand – it would be to have commonality of objectives to achieve consistency across the process from company to investment consultant to fund manager.

Quote from consultation workshops.

Our proposals

In the area of pension funds – investment objectives - we propose:

The Myners Review set out a comprehensive framework covering the need for tougher and broader Statements of Investment Principles and explicit mandates. There is a need for the industry to continue to implement this agenda, in particular:

- * *Investment consultants should ensure that pension fund trustees are aware of the importance of these changes and that in their role as intermediary they should encourage pension trustees to set out their expectations more clearly.*
- * *Mandates should be established on the assumption that they are for the long-term, ideally seven to ten years, with a regular review cycle. These should be based on appropriate ways of benchmarking success – such as a customised portfolio of bonds, inflation-linked or absolute returns, comparing returns against a range of simulated portfolios or using indices that are not based on market weighting. (For examples of alternative indices see Appendix 7.)*

A sense of responsibility and accountability is required from all sides. Consultants must be accountable for the asset liability studies they provide to trustees and fund managers should be included in the discussion when seeking solutions to long term liability issues.

Quote from consultation workshops.

- * *The relationship between pension fund trustees, investment consultants and fund managers should be reinforced by, for example, working through scheme mandates to ensure that the fund manager has a full understanding of the rationale and the underlying liabilities and is therefore fully committed to the objectives.*

In the area of remuneration and incentives – we propose:

Performance related fees can provide a way of having shared objectives – the pension fund trustee, investment consultant and company have to work together to define and understand what is wanted.

Quote from consultation workshops.

To ensure that they support conduct consistent with the delivery of the objectives set out for a particular contract:

- * *The basis on which fees and other financial incentives are calculated should include a performance-related element and be transparent to all the parties to a contract, including the ultimate investor. Fund managers' fees should be more closely related to performance than to the size of funds under management.*
- * *All companies should explain the rationale behind their pay arrangements. Performance systems should be designed to ensure the remuneration of the most senior directors is not excessive in relation to overall performance and remuneration levels across the rest of the organisation.*
- * *The performance-related remuneration of executives should be based on a greater weighting of shares against options to achieve better alignment with the performance of the company.*
- * *The various associations and professional bodies should collaborate to develop best practice from the numerous sets of guidelines already in place.*

In the area of transparency of charges – we propose:

- * *That all parties across the system should provide full disclosure to their clients, including the ultimate investors, of all fees and charges, including those which are currently 'hidden'.*

In the area of conflicts of interest – we propose:

- * ***Across the system as a whole:***
 - *Where it is not possible to manage these effectively then ultimately more radical solutions should be considered – at the very least the separate management of conflicting roles within the same organisation and transparency regarding the profitability of each. Access to independent advice is vital and should be readily available to all members of a company board should they feel that the interests of the company may be adversely affected.*

*** In the area of mergers and acquisitions:**

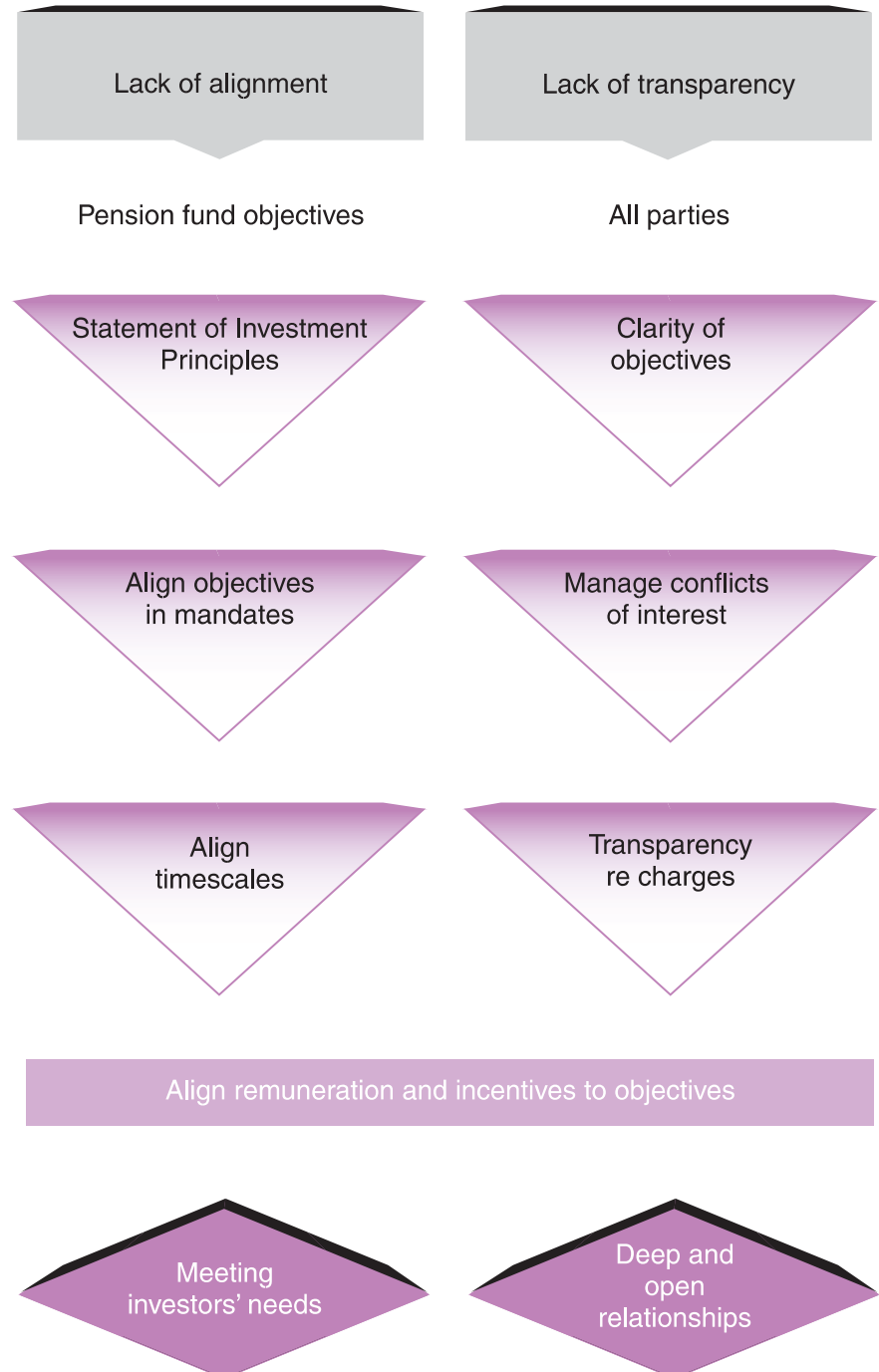
- *The company's non-executive directors should seek independent advice. Such advisers need to be free of conflicts of interest having no other relationship with the company. These arrangements are always employed when executive directors seek to buy out their whole company. Accordingly, the non-executive directors negotiate on behalf of all shareholders and retain independent financial and legal advisers. The same principle should apply to significant bids and merger proposals of managements, and to their proposed takeover defences.*
- *Companies should commission an independent audit of the acquisitions they have made on a regular basis over the five years or so following an acquisition to assess whether the transactions did serve to create shareholder value. Such reviews should be prepared for the non-executive directors. It would also be in the long-term interests of investment banks to participate in these reviews to refine their own advisory practice. In the longer term, such evidence should be expected to be part of the OFR and presented to shareholders at the AGM or at the strategy conference suggested in the section on 'Evaluating long-term business success' – see page 94.*

*** In the area of research:**

- *That although some steps have already been taken by investment banks to draw clear lines between their activities, in future all providers of investment research should be expected to make clear any relationships that might lead to a possible conflict of interest. The fund managers purchasing research should stipulate this as a condition of business, and the pension fund trustees in their mandates should be able to expect fund managers to make transparent and/or address and manage all such conflicts.*

Trust and integrity – alignment and transparency

Putting it all together



Area for Change 3 - exercising ownership rights and responsibilities

Introduction

Those to whom major powers are entrusted must be accountable to those whom they serve. Boards of directors must, therefore, be accountable to shareholders.

Pension fund trustees and other fiduciaries have rights and responsibilities relating to the companies in which their funds own shares – and whilst most delegate the day to day management of these to fund managers, such intermediaries must also be accountable to the ultimate beneficiaries, whether an individual investor, pension fund member or policyholder.

In practice, we might generally expect the extent to which ownership rights and responsibilities are exercised to depend on the duration of the shareholding. Those who own a company's shares for a short time might well pay less attention to such matters than a longer-term shareholder who would be more interested and active in a company's governance.

The short-term shareholding associated with certain types of active investment management is a legitimate activity, which facilitates amongst other things stock market liquidity and the pricing of shares. But, it would be unlikely to suppose that such shareholders would choose to assume the same responsibilities as long-term institutional share owners, such as pension funds and insurance companies.

We believe that the investment system is currently deficient because, despite the encouragement of government and others, many of the fiduciaries representing companies' largest shareholders have effectively abdicated their responsibilities as owners.

'Those to whom major powers are entrusted must be accountable to those whom they serve.'

As observers from Adam Smith to Hayek and Milton Friedman have long observed, no-one looks after assets as well as the owners... Putting owners in charge of what they own is of course the purest form of capitalism.

Robert A G Monks and Allen Sykes.¹

Previously owners acted as real shareholders, they were closely involved, knew the company and would cause grief. Over the last 50-100 years the majority ownership has moved to institutional investors and a huge distance in understanding and involvement between the managers of the company and the investors has been created with many intermediaries in the relationship. Managers have an impossible task – they have to satisfy all the shareholders who have different expectations, pressures and requirements. Companies are able to take liberties in terms of executive remuneration, benefits etc. What an individual employee receives compared with a shareholder or a CEO is disproportionate. It is this distance between those who run the company and those who own it that is the core issue.

Quote from consultation workshop.

‘Crucial to improvements...will be the quality of the dialogue...’

I think the fund management community must understand its responsibility and not just its power. In other words we have a major responsibility as aggregate allocators of capital in the economy. We must make sure that the capital of our savers, the ordinary men and women of Britain who contribute to their pension funds, that that capital is appropriately applied. It's as stewards of other people's money that we apply pressure and governance to, or pressure on company management and make sure governance is adequate. I think we must be very careful not to see ourselves as the end owners and the all-powerful people being able to just boss industry around. That's not it. We are stewards of other people's money and we want to make sure that that capital is properly applied.

Hendrik Du Toit,

Chief Executive Investec Asset Management.²

If corporate and general prosperity is to be encouraged long-term share owners or their fiduciaries need to engage with and support company directors in their long-term decision-making. To facilitate this, we need to consider carefully the roles of the owners and their representatives, (specifically the fund trustees or other fiduciaries, investment consultants and fund managers), in what might be called ‘the chain of corporate accountability’. In particular, we need to define clearly the relationships and processes which will promote the contribution of shareowners to the long term performance of companies by holding directors to account.

Why the ownership dialogue is important

Crucial to improvements in this area will be the quality of the dialogue between institutional shareholders and companies, which should extend well beyond voting at shareholder meetings. For example, to add value there is a need for appropriate representatives of institutional shareholders to:

- * *have a good understanding of a company's business and to be able to engage constructively with its board*
- * *ensure that they are aware of and reflect the attitudes, interests and concerns of the company's ultimate owners.*

Unfortunately, many fund managers do not have the experience, competence, systems, processes, resources or, in many cases, the desire to make informed judgements on matters affecting the longer term sustainability of companies – nor are they prompted by their clients and intermediaries. Corporate governance, including social and environmental performance, is generally given only formulaic consideration. In this respect the short-term outlook of the long-term owners of UK companies can be regarded as a systemic weakness – one in which many of the investment system's participants are complicit. A failure to recognise and address this weakness undermines UK plc.

The enfranchisement of small shareholders, often themselves long-term owners, should be considered. One in seven shares in the UK is directly owned by private shareholders, but with the advent of CREST, the settlement system for UK shares, most are now held in nominee accounts. Whilst there are initiatives to help ensure that the nominees keep shareholders regularly informed, such as the voluntary ‘ProShare Nominee Code’, corporate documentation and other information often does not reach the owner.³ There is therefore a gap between companies and individual investors, who unlike institutional shareholders are often overlooked in terms of access to information and the ease with which they can exercise their rights.

Changing patterns of share ownership
Beneficial ownership of UK shares (percentages)

	1963	1990	2002
Rest of world	7.0	11.8	32.1
Insurance companies	10.0	20.4	19.9
Pension funds	6.4	31.7	15.6
Individuals	54.0	20.3	14.3
Collective vehicles*	12.6	8.4	13.9
Charities	2.1	1.9	1.1
Other	7.9	5.5	3.0

* Unit Trusts, Investment Trusts and OEICs.
 Source: Office of National Statistics.

Corporate governance and exercising ownership adds value

A number of studies have sought to examine the link between governance and performance. These studies have been summarised by Hermes and are outlined below.⁴ The studies followed three basic approaches:

- * **Opinion-based** – these support the view that investors appear to favour companies that they perceive to have a relatively high quality of management. The most well-known is the ‘Global Investor Opinion Survey’ of over 200 institutional investors first undertaken in 2000 and updated in 2002. McKinsey found that 80% of the respondents would pay a premium for well governed companies.
- * **Governance ranking** – most of the research into the connection between corporate governance and investment performance seeks to link an objective and relative measure of the quality of a company’s governance to movements in its share price. This approach has had varying degrees of success, with some researchers claiming either no link or a negative one. ‘Corporate Governance and Equity Prices’ by Gompers et al in 2001 is the most celebrated governance ranking study supporting a positive link. Using a universe of 1,500 US companies, this research had an impact because it proposed an active investment strategy based on corporate governance structure and rankings. These findings were successfully replicated in Europe, concluding that portfolios of companies with high corporate governance standards do have better performance than those with poor standards.
- * **Focus list** – this research provides the most convincing evidence for a causal link between corporate governance and company performance. Unlike the opinion-based and ranking research, it is relevant to markets with different governance structures. ‘The CalPERS Effect’ (California Public Employees’ Retirement System), first described in 1994 and updated in 1995 and 1997, continues to represent the most influential research in this area. Based on the last update in 1997, CalPERS focus list companies outperformed by 23% in five years after focus listing, compared to 89% underperformance in five years before. However, the CalPERS effect has been replicated elsewhere with only limited success. Nevertheless, a related study undertaken by the Institute of Business Ethics found that larger UK companies with codes of ethics outperformed those which claimed not to have such codes.

One of the main challenges facing policy makers is how to develop a good corporate governance framework which can secure the benefits associated with controlling shareholders acting as direct monitors, while at the same time, ensuring that they do not expropriate excessive rents at the expense of other shareholders. The empirical evidence to date suggests that this is indeed a problem and that protection of minority shareholders is critical to the development of active equity markets. Maher and Andersson.⁵

In a survey of over 130 pension fund trustees undertaken by Ashridge and Just Pensions in 2004 - trustees were asked to what extent six areas of corporate behaviour would impact on the market value of the FTSE100 in both the short and longer term. ‘Good corporate governance’ was seen as the most significant of the six identified issues in the short and longer term. A third of trustees thought that it would have a substantial positive impact on the market value of quoted companies within one year and this figure increased to 42% when asked to consider the next 5-10 years.⁶

‘...the corporate governance structure itself is less important than the extent to which ownership oversight is exercised’

Everyone – government, investors and companies – seem to be agreed that legislation would be the worst possible method of improving governance standards further...These matters are simply not susceptible to laws.

Alastair Ross Goobey.⁸

‘...increased regulation...is likely to add cost without generating benefit.’

I have considered very carefully the question of whether to introduce further legislation in this area and have concluded that this is not necessary at this stage. I agree with the conclusions of the Trade and Industry Committee report and the comments of its Chairman that the recent examples of increased activism by institutional investors, and the promotion of best practice have the potential to remedy the situation. The Government should wait and see the effect of these developments before it considers legislative remedies.

Patricia Hewitt. The Secretary of State for Trade and Industry.⁹

Hermes concluded from its review of the evidence and its own experience that there is a link between the way in which a company is governed and its performance, and in particular a link between active ownership and improved performance of companies that have potential to improve. The study also suggests that the corporate governance structure itself is less important than the extent to which ownership oversight is exercised.

Government policy

As a result of the tax incentives offered to pension funds and individuals saving indirectly through the retail market, successive governments have pushed the UK to a position where it has one of the highest proportions of corporate ownership by institutional investors in the world. Accordingly, the UK government takes a continuing interest in whether institutional investors are playing their part in promoting effective governance.

Patricia Hewitt, Secretary of State for Trade and Industry, speaking at a conference in London in November 2003 stressed the need for financial institutions to become accountable to the millions of people whose savings they handle, disclosing their investment criteria and how they vote their shares. “It’s not just about exercising ownership. It’s about being transparent about how you are using your ownership as well.”

Ms Hewitt stated that mandatory voting is not an option but that voting records should be made more available, including to potential new investors. “Too many fund managers, when faced with under-performance, continue to support inadequate management. Others simply pull the plug and switch investments. So a merger or takeover becomes the only route to replacing failed management. By insisting on a change of management, active owners can create real value for investors and future pensioners.” She criticised the 50 per cent voting levels at this year’s annual meetings as ‘simply unacceptable’. “Millions of votes are simply going AWOL and people disenfranchised.”

Meanwhile, Paul Myners, the former fund manager who led a review of institutional investment, has been made chairman of an industry group to review obstacles for fund managers in voting. The Shareholder Voting Working Group was set up in 1999 to tackle such problems as votes getting ‘lost’.⁷

However, interest that turns into intervention may have unintended consequences. Responding to corporate scandals and fraud with increased regulation, as has been the case in the US, is unlikely to solve these problems on its own and is likely to add cost without generating benefit.

It is both the industry’s and the current government’s view that it would be preferable to start by building on the best practice and standards which have already been developed and which can continue to evolve in line with changing circumstances. Nevertheless, these need to be reinforced with greater transparency and attention to the accountability of the investment system’s various agents. Insofar as any additional regulation or legislation is required, it should be aimed at enabling share owners to exercise their rights and responsibilities.

Some thoughts on best practice

The nature of the dialogue between shareholders and companies

Shareholder engagement can be a positive force, but it needs to be carried out with intelligence and integrity. The UK Combined Code's Principles on shareholder and company dialogue calls for companies to listen to their shareholders' views and concerns and respond appropriately. In turn, shareholders need to recognise that the board is likely to have greater knowledge of the company's operations and should not seek to micro-manage the business.

The Institutional Shareholders' Committee's (ISC) Statement of the Responsibilities of Institutional Shareholders and Agents sets out examples of issues which may form the basis of such a dialogue. (See Appendix 8.)

Open and transparent communication is vital, as is trust. Engaging with the company in a constructive and ongoing manner is the best way to solve potential conflicts. Highly public intervention usually means that this process has been ineffective.

It is essential that shareholders, as owners, recognise that they have responsibilities to monitor and normally to support the work of the management of the companies in which they invest. Good corporate governance is about dialogue and the promotion of success. Confrontation is a sign of failure by owners or Boards or, sometimes, both. The NAPF considers that the informed use of votes is an obligation (although not a legal duty) of owners and an implicit fiduciary duty of trustees and of investment managers to whom trustees may delegate this function. In recognition of this, the NAPF policy will recommend active voting, in support of management wherever possible, but will recommend a vote against, where appropriate. Recommendations of abstention will rarely be made and, whenever such a recommendation occurs, it will be carefully explained why the NAPF considers that this is the appropriate course of action. Engagement with companies is a necessary part of good ownership. The NAPF and its associates will engage with companies at various levels on routine and more serious matters. In addition the NAPF is prepared to facilitate confidential Case Committees for members who have concerns about particular issues and/or about the strategic direction of companies. Equally, companies should take great care to ensure that their messages are clearly understood by shareholders and that the concerns of the shareholders are clearly understood by the Board. The roles of the chairman and the senior independent director in these regards are of the greatest importance. *National Association of Pension Funds Limited (NAPF).*¹¹

The process of demanding accountability through engagement can be valuable even when a company is performing well. From discussions with the best companies, institutional shareholders can hear at first hand what works and why, and this can help them in their discussions with other companies. It also helps to build long term working relationships between shareholders and boards so that the lines of communication are always open.

'Shareholder engagement can be a positive force...'

There needs to be a new dialogue between companies and investors so that issues can be discussed before things come to a head. Many companies are surprised by shareholder activism - companies and investors have to come together in a non-confrontational way.

Quote from consultation workshops

'Open and transparent communication is vital, as is trust'

I don't think investors should be absentee landlords, and at Jupiter, we try to concentrate on those companies where we've got most leverage, i.e. Are we in the top five shareholders? Can we make a difference? Do we have a strong view on the structure or the strategy of the company? And then you should let management get on with it, within those confines.

*Edward Bonham Carter,
Chief Investment Officer,
Jupiter Asset Management.*¹⁰

‘Good governance and accountability are about better performance, and are not ends in themselves.’

It is more productive when the relationships between institutional shareholders and companies focus on factors relating to long-term financial performance rather than compliance with codes of governance. Good governance and accountability are about better performance, and are not ends in themselves.

The International Corporate Governance Network (ICGN) Statement on Institutional Investors Responsibilities sets out a framework of best practices on the implementation of fiduciary responsibilities in relation to equity shareholdings. As such it is meant to apply to institutional shareholders and their agents around the world. It addresses the entirety of those relations - not just the shareholders' responsibility to vote. At the same time, it recognises that the principles it describes need to be dealt with pragmatically. The ICGN Statement considers certain issues as important.

- * *Transparency - this is at the root of all good governance principles. It means better information and better accountability, not necessarily more information.*
- * *Operational performance and strategic issues - it is vital that investors have adequate information on any substantial changes in control structures, particularly financial ones.*
- * *The role and responsibilities of the non-executive directors - are they truly robust and independent?*
- * *Succession practices and procedures - are there adequate procedures in place?*
- * *Board composition and compensation - does the composition of the board reflect the needs of the individual business? Institutional shareholders should be encouraging companies to have rigorous and transparent procedures in place for board recruitment and training and compensation packages.*
- * *Shareholder rights - is the level of shareholders' rights appropriate and is there adequate protection for them?*¹²

In the longer run, shareholders can increasingly be expected to use the internet to express their views and exert their influence, as is becoming the case in North America. This activity is not just in response to on-line reporting or corporate communications, but is expanding to include sites which are specifically designed to challenge the management of particular companies and to co-ordinate shareholder activism.

The US Council of Institutional Investors is an organisation of large public, labour funds and corporate pension funds which seeks to address investment issues that affect the size or security of plan assets. Its objectives are to encourage member funds, as major shareholders, to take an active role in protecting plan assets and to help members increase return on their investments as part of their fiduciary obligations.

Founded in 1985 in response to controversial takeover activities that threatened the financial interests of pension fund beneficiaries, the group began with 20 member funds. Today the Council has over 130 pension fund members whose assets exceed \$2 trillion, and more than 125 honorary international participants and educational sustainers. It is recognized as a significant voice for institutional shareholder interests.¹³

Collaborative action

Collaborative action can enable shareholders, whether institutional or individual, to have more influence and leverage.

The ‘free-rider’ problem is often cited as a barrier to collaborative action. At present, so long as there are some active shareholders, inactivity pays for the majority. Inactive institutions gain the benefits of successful intervention at no cost to themselves. There is often little incentive for responsible shareholders to intervene and generally a ‘no lose’ situation for irresponsible or inactive ones. This is the essence of the ‘free rider’ problem, to which the normal play of market forces offers no solution – albeit the collective benefits may be considerable and greater if shareholders work together. The aggregation of ownership is a way of overcoming this problem.

From the company’s perspective, it is often cumbersome and costly to deal with the concerns of shareholders individually, making a collective view more efficient.

‘Collaborative action can enable shareholders...to have more influence and leverage.’

There may be a large potential gain for the group as a whole from collective action, but there is insufficient incentive for individual action, particularly when many of the entities, for example, fund managers, are in competition. In the case of corporate governance the position could hardly be less favourable to collective action. There is not just one large group that needs to act but several, each with little contact with the others, and in the case of the many millions of individual and underlying beneficial shareholders, none at all. This explains why despite the many worthy attempts at corporate governance reform in the last decade particularly in Britain, achieved too little. The groups’ individual incentives and conflicts of interest have proved impossible to overcome by what were essentially appeals for more enlightened behaviour without effective sanctions.

*Robert A G Monks
and Allen Sykes.¹⁴*

Agenda for change

'Companies whose managers are accountable to effective owners are more likely to be better managed.'

There is an ownership vacuum. The performance of companies will be improved if it is recognised that there must be a greater involvement of those who own the company.

Companies whose managers are accountable to effective owners are more likely to be better managed.

The effective exercise of ownership rights and responsibilities is about much more than monitoring standards of corporate governance. It is about holding boards accountable for performance and for acting more generally in the long-term interests of shareholders.

There needs to be a better dialogue between companies and institutional investors. In addition, better arrangements are required for individual investors to exercise their ownership rights and responsibilities.

Our proposals

In the area of definition, clarity and monitoring – we propose:

** All institutional shareholders should comply with the ISC's Statement of the Responsibilities of Institutional Shareholders and Agents which sets out best practice for institutional shareholders and their agents in relation to their ownership responsibilities and suggests that they should:*

- set out their policy on how they will discharge their responsibilities – clarifying the priorities attached to particular issues and when they will take action*
- monitor the performance of, and establish, where necessary, a regular dialogue with investee companies*
- intervene where necessary*
- evaluate the impact of their activism and*
- report back to clients/beneficial owners.*

* *That the largest institutional shareholders, such as pension funds, should consider working together on a more formal basis to support the directors of companies, in which they jointly invest, in making decisions which are in their long-term interests. Rather than each shareholder building up the substantial and senior resource required properly to exercise their ownership rights and responsibilities, resources could be shared or pooled in order to be more effective and provide companies with consistent messages. In addition, they should adopt the following best practice:*

- *provide companies with a statement of what is expected of them (Appendix 9 gives an example of such a statement)*
- *attend company general meetings more frequently*
- *provide prompt and full responses to companies' requests for information and consultations on matters such as board changes and executive compensation and director elections*
- *provide companies with an explicit statement of how they will exercise the obligations of ownership.*

* *In order to provide a stronger incentive for large shareholders and their agents to exercise the ownership function where this is appropriate to the mandate, we propose consultants should develop ratings and rankings of fund managers in terms of their 'effectiveness as owners' for use in 'beauty parades' and through this process we envisage:*

- *Fund managers and investment providers competing for business would regard it as normal practice to disclose not only their financial track record but their current ranking in the ownership 'league table'.*
- *Pension fund trustees and retail customers would be able to choose products based on the results. There would be competition awards for the best owners, and kite marks for those who achieve an acceptable standard.*

In the area of voting – we propose:

* *The adoption of the recommendations set out in Paul Myners' report to the Shareholder Voting Working Group (SVWG).¹⁷*

* *Institutional shareholders should disclose their voting records to their clients. However, there should be no requirement to do this within three months of the relevant general meeting, as the most active shareholders often have ongoing engagements with companies which could be damaged by public disclosure. Such disclosure should help restore trust and confidence in the investment process. Several examples have been set – such as ISIS, Jupiter and Morley Fund Management.¹⁸*

How can index fund managers such as Barclays Global Investors (BGI) - which can own as many as 600-800 of the firms in one share market - apply good practice? Marian Collins, BGI's head of corporate governance, says its extensive ownership of the market makes its commitment to good governance even more important. It cannot just sell shares and walk away. "We are there for the long term, so if we want to change a company we have to use engagement with the company or our voting rights to achieve change."¹⁵

I think it's important that investors understand that their votes are a part of the asset that they acquire when they invest in company shares. If we've been as an industry a little too passive in voting our shares in the past, it's probably a good thing if we're a little bit more active now.

*Alan Brown,
Chief Investment Officer, State Street Global
Advisers.¹⁶*

In the area of competence and conflicts of interest – we propose:

* *OEICs and investment trusts should have independent boards constituted so as to exercise their ownership responsibilities effectively and protect the interests of individual investors.¹⁹*

There is a business case for CSR. But it is not in the superficial form that is often claimed. The convincing and enduring business case...sees corporate responsibility as one of the outputs you can expect from a well-led company. But, while particular companies in particular circumstances may enjoy business benefits from particular CSR programmes, you cannot make the leap which somehow argues that because companies adopt CSR programmes or practices they will as a result be more successful. There is, on the other hand, evidence to support the view that well-led companies, which are clear about their purpose and values will create more shareholder value than companies which simply and expediently talk about making money.

Tomorrow's Company. ²⁰

In the current system, private shareholders are for all practicable purposes disenfranchised, as their votes at shareholder meetings are almost invariably outweighed by the (usually) proxy votes of the institutional shareholders. Beneficial owners, represented by those same institutional holders, are also effectively disenfranchised; for, as we have seen, the institutions almost invariably make no attempt to discover what the beneficial owners believe their interests to be. Furthermore, neither private shareholders nor beneficial owners are privy to the content of meetings between the representatives of institutional shareholders and company directors, so there is inequality in the information available to institutions and individuals.

Iain Vallance. Deputy Chairman, Royal Bank of Scotland. ²²

- * *Providers of investment products generally, including companies using insurance policies as the basis for these products, should have the equivalent of an independent board or advisory group which reports regularly to investors or policy-holders with an assurance that the investors' interest has primacy in the investment decision making process.*
- * *Institutional shareholders should identify their own potential conflicts of interest and put in place transparent corporate governance procedures to deal with them.*
- * *Fund managers should indicate in their clients' voting reports, those companies in which they hold shares, those which are clients and those general meetings at which they voted. This information should be presented so as to allow an assessment of the consistency of their voting policies.*
- * *Institutional shareholders' corporate governance specialists should have sufficient practical experience of the workings of public company boards to make informed and professional judgements.*
- * *They should have a sufficient number of such specialists to develop a thorough understanding of the application of corporate governance, including corporate social and environmental responsibility and to integrate this consistently into the analysis of each of the companies in which they invest.*
- * *Trustees or other fund fiduciaries should canvass beneficial owners on their expectations concerning the governance and remuneration policies of the companies in which their funds are invested.*
- * *Robust systems of reporting and accountability should be in place at every stage in the investment chain.*

In the area of wider shareholder involvement:

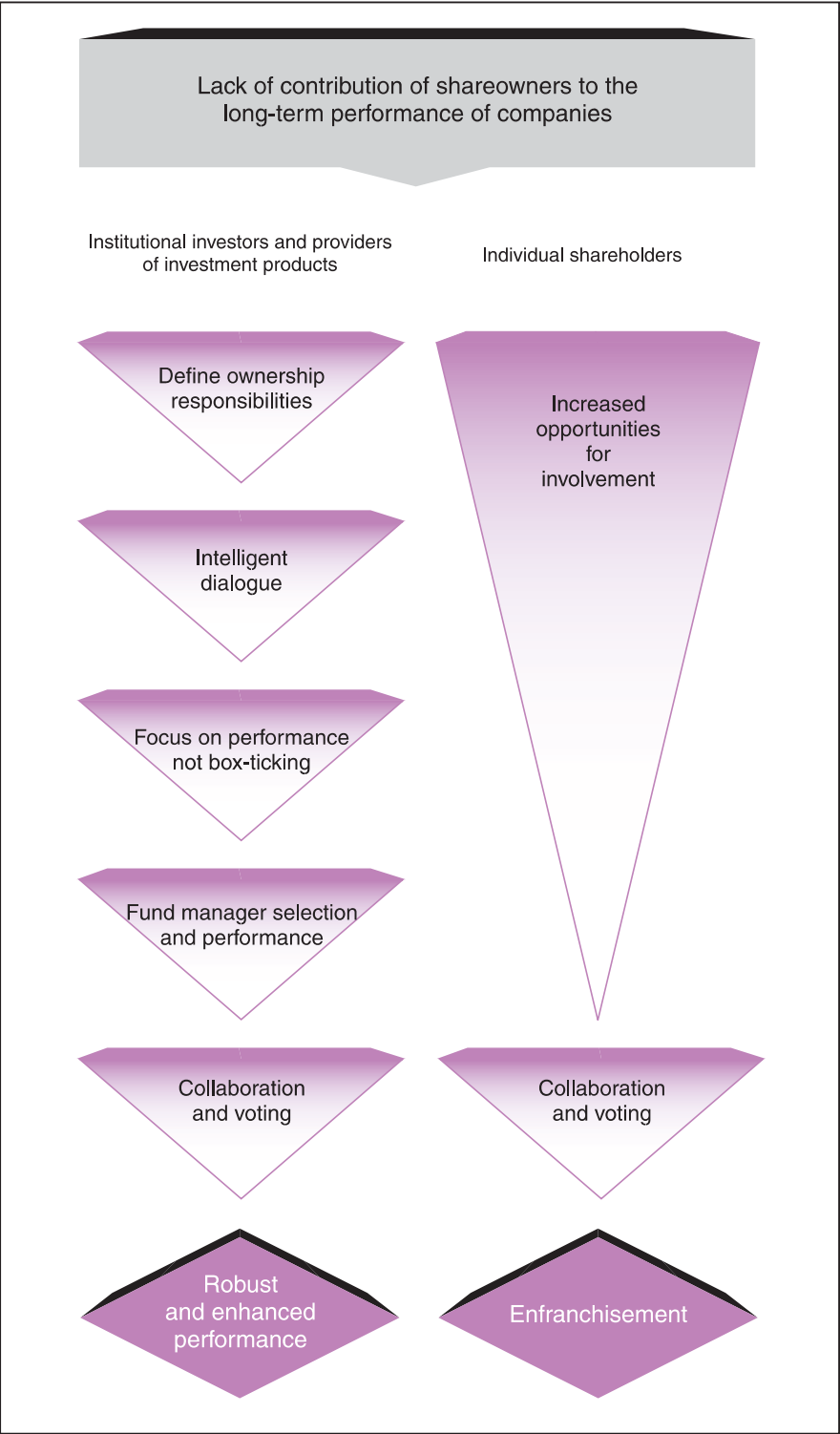
The focus up to this point has been on the rights and responsibilities of institutional investors. Until these issues have been addressed it is premature to identify the appropriate mechanisms for individual shareholders.

However, a number of ideas have been put forward to the inquiry to address the imbalance in shareholder democracy. We have included below those which might be considered by the most progressive companies:

- * *Quoted companies establish Shareholder Select Committees, which could:*
 - *be charged with representing the interests of all shareholders*
 - *request information on the interests of their members and issue annual reports on their activities*
 - *act in an advisory capacity to board members and shareholders. (There would be a need to modify 1855 & 1862 Limited Liability Acts.)²¹*
- * *A requirement that all shareholders' meetings be broadcast on the internet, with shareholders being able to vote on-line.*
- * *Significant analysts' conferences be broadcast on the internet, enabling private shareholders to take part.*

Trust and integrity – exercising ownership rights and responsibilities

Putting it all together



Area for Change 4 - evaluating long-term business success

Introduction

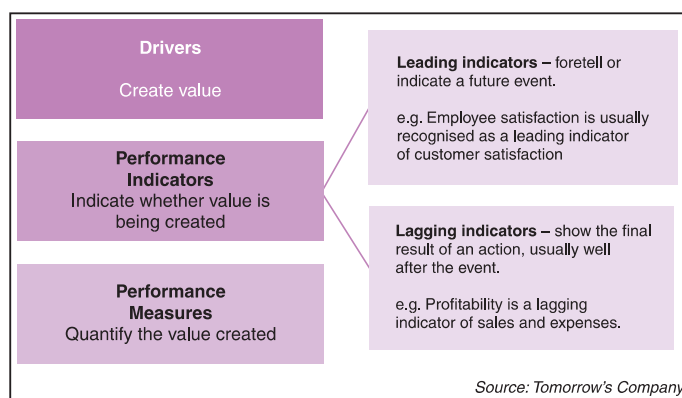
Companies are the wealth creating engines of the economy. We depend on them to sustain employment, living standards and public services. The resources invested in companies are predominantly the savings of individuals, most of whom want a sound return over the long term. In order for those needs to be met companies have to sustain their ability to deliver returns over time by focusing on those areas in which long-term economic returns can be generated.

Different investors have different timeframes. Certain investors holding shares for very short periods will use different metrics to investors such as insurance companies and pension fund trustees which are more concerned with the sustainability of a company's performance over longer periods. This section concentrates on the latter and on the issue of the information companies and the investment community should focus on when considering what drives the performance and long term success of a company.

'...focus on what drives the performance and long term success of a company.'

What is meant by drivers of company performance and performance measurement

This is a subject of much discussion and an area that has given rise to a multiplicity of terms and models. The lack of a common language and understanding can itself present a problem, but is not an element of the debate that we wish to pursue here. For the purposes of this document we have confined ourselves to outlining a model of business performance and the related information requirements as shown in the diagram below.



What information is needed

Efficient markets require good information – investors need to be able to choose between different companies and to reach reasonably valid decisions as to which ones will provide the best return for the money invested.

The information that is required should fulfil the following criteria:

- * *Objectivity – free from distortion arising from conflicts of interest*
- * *Accuracy – representing ‘a true and fair view’*
- * *Relevance – including all appropriate facts.*

To meet these criteria, analysis of a company’s performance needs to be as complete as possible and take into account both financial and non-financial information. Whilst the importance and use of non-financial information has been established for many years, there is still a tendency for companies and institutional investors to focus on historical, financial, numerical and short-term data.

This focus on the short-term ‘numbers’ is heavily influenced by the culture and mindset that exists in the City – and becomes even more prevalent in a difficult business climate.

Diminishing time horizons are a factor. Any fund house will have a screen reporting movements in real time – everyone is thinking short-term.

The heart of the problem is a failure of communication – people believe parties act in a certain way. Companies believe that fund managers are only interested in a one year horizon – fund managers believe that a sponsoring company’s patience runs out after two years of underperformance – and fund managers believe that investment consultants support this. Pension fund trustees feel that the sponsor will blame them if performance is only 20% vs. 22% and they don’t get any thanks when performance is fine. The consequence is a circular discussion about short-termism.

Isn’t the most important consideration for the industry to keep the customer in the market? Short-term performance is important because judgements are based on this. Trustees are afraid of litigation, fund managers are afraid of losing clients, investment consultants are paid when switching takes place. None of this fits with the long-term investment needs of the saving public.

I have a belief in building long-term value of the brand and the business for shareowners. This is a long-term quest. However I am increasingly faced with the long-term vs. short-term issue – the reducing horizon over which performance is measured – quarterly – the reality of being caught up in a short-term cycle which seems contrary to what business is about.

Quotes from consultation workshops.

However, in an increasingly complex, volatile and interconnected global business environment, there is a need to shift the balance between ‘historical quantification’ and predictive measures and between financial and non-financial information.

As well as the need to broaden the analysis of company performance to include non-financial as well as financial factors, it is also important to recognise that different kinds of performance data are used for different purposes. There is a danger if information created for one purpose is used to support another.

‘...analysis of a company’s performance needs to be as complete as possible...’

At its heart, an overemphasis on achieving and maintaining short-term financial results can cause companies to overinvest in short-term fixes and to underinvest in long-term value creation, particularly in the intangible and intellectual assets that generate future growth.

Robert S. Kaplan and David P. Norton.¹

‘...different kinds of performance data are used for different purposes.’

Success for organisations today is measured very differently than it was yesterday. Of course financial performance is essential. Delivering profit growth or enhancing shareholder value is still the top of every executive’s agenda, but it is now widely recognised that delivering financial performance alone is insufficient. Even more importantly, it is now generally accepted that the level of financial performance achieved today is a function of decisions made 6-18 months ago, or even longer...Senior executives have to get the balance right between short-term harvesting and long-term sowing. That, after all, is what they are paid for and, if they are directors of public companies, what they are elected to do by their shareholders.

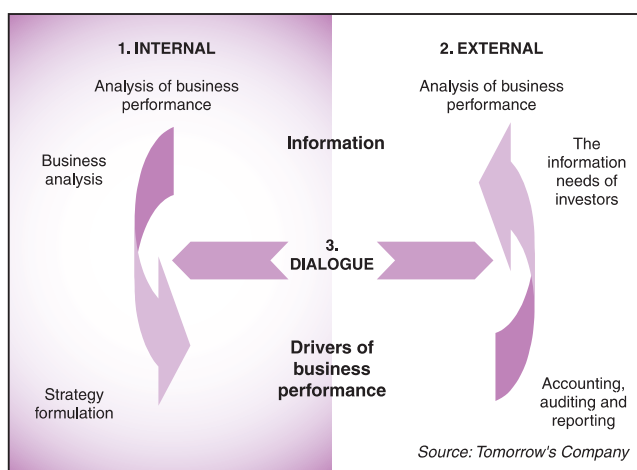
Andy Neely, Chris Adams and Mike Kennerley.²

The requirements for information are:

1. Internal analysis of business performance – the company's need to generate quality information to support business decisions.

2. External analysis of business performance – this covers the information demanded by regulation, standards and law and increasingly a whole range NGOs.

3. Dialogue – information required by investors seeking to assess the company's performance – this may be less formal, the type often depending on the quality of the dialogue, the knowledge or particular interests of the user e.g. ethical considerations.



'Companies need to be in a position to supply the right information and users need to be able to ask the right questions.'

For an effective dialogue to take place, and one which is focused on future value creation, companies and external users of information need to have an interest in and understanding of what drives a particular company's business success. Companies need to be in a position to supply the right information and users need to be able to ask the right questions.

There are gaps in knowledge, communication and purpose which must be closed if this is to be achieved:

1. The knowledge gap – between the body of knowledge that exists regarding the drivers, indicators and measures of sustainable company performance and what is, in practice, used in companies and for investment research purposes.

2. Communication gaps – a study by PricewaterhouseCoopers identified five communication gaps:

* The information gap – where the lack of relevant information can lead to a particular company being either overvalued or undervalued:

- When the market lacks the information it considers important, perhaps because the company is unable to provide it on a reliable basis, it will tend to be over cautious. The valuation may therefore be set at a lower level than the company believes appropriate because the managers of the company have access to more information and better understand the company's future strategies and plans.
- Equally, lack of relevant information can lead to over valuation if there are problems in the company which are not made known. Ultimately the 'truth will out', but sometimes with disastrous consequences.

- * *The reporting gap – between the importance managers attach to a measure and how actively they work to report on it.*
- * *The quality gap – between the importance managers attach to a measure and the reliability of the information provided on it by their internal systems.*
- * *The understanding gap – between the measures that company managers consider important and those to which analysts and investors attach significance.*
- * *The perception gap – between how actively managers think they work to report on a measure and how analysts and investors perceive the adequacy of that information.*³

3. The gap in purpose – Companies and those analysing its performance or investing in it often have differing aims:

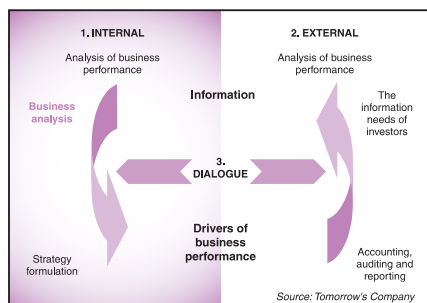
- * *Companies are concerned with future performance in terms of profitable growth. Analysts, researchers and investors may focus on the short-term share price, not the future of the company itself. (For example, a company which has a chain of top quality hotels might, during a recession in the tourist industry, spend heavily in refurbishment, thus sacrificing current profit in favour of future returns. An analyst or researcher may simply react to the sector downturn and the company's lowered profitability and mark the stock down.)*
- * *The difference in the understanding and measurement of business and investment risk by different parties in the process:*
 - *Companies focus on a wide range of issues when assessing business risk i.e. brand, reputational and environmental risk.*
 - *Fund managers may focus on their own short-term business risks and overlay such considerations when making investment decisions e.g. the potential for their losing business, rather than the client's risk.*

Criteria for judging companies. Base: Various Audiences, Latest Results 2003

Q. What are the most important factors you take into account when making a judgement about a company? (spontaneous; top two highlighted).⁴

	General public	MPs	City	Financial press	Captains of industry
Financial performance	12	33	69	91	40
Treatment of staff	12	50	6	36	8
Customer service	22	21	7	39	7
Quality of management	11	3	73	82	30
Image and reputation	–	14	17	33	48
Quality of products	25	22	31	55	21
Social responsibility	2	38	5	18	6

1. Internal analysis of business performance



'The factors that help a company maintain its competitive position are often non-financial and intangible...'

Business analysis

Management accounts are there to help managers make judgements of past performance and decisions about the future. The raw data used to compile management accounts include, inter alia, sales revenues, costs, prices, and cash flows. Analysis of these data provides such information as margin by product, profitability by customer, the anticipated internal rate of return from capital projects, and measures of added value.

The factors that help a company maintain its competitive position are often non-financial and intangible in their nature. They include:

- * **customer service excellence** – a prerequisite for customer satisfaction, acquisition and retention, loyalty, repeat sales and market share
- * **employee commitment** – loyal and committed employees provide better customer service – they are also less likely to leave so recruitment and training costs are lower
- * **quality of leadership** – the importance of the role of the board and senior managers in leading and controlling the business and as a result their impact on the profitability of the business
- * **attracting, developing and retaining talent** – the capability to recruit, develop, retain and manage staff, with the competencies essential to a company's organisational performance and success
- * **brand strength** – this can be a firm's most valuable asset
- * **reputation** – especially in areas such as environmental and socially responsible issues.

A progressive approach to managing people pays dividends

The failure of many analysts to understand and take account of the fundamental drivers of business success is illustrated by the example of Costco.

According to Business Week (April 12 2004) Costco Wholesale Company beat Wall Street expectations by posting a 25% gain in profits in the previous quarter on top of a 14% increase in sales.

The market response was to mark the company's stock down 4%.

The company pays its staff much better than its main rival Walmart and provides significantly better healthcare and pension benefits. Analysts were worried that Costco's operating expenses might get out of hand.

Yet a closer look shows that Costco's high wage approach is associated with outperforming Walmart on a range of key measures.

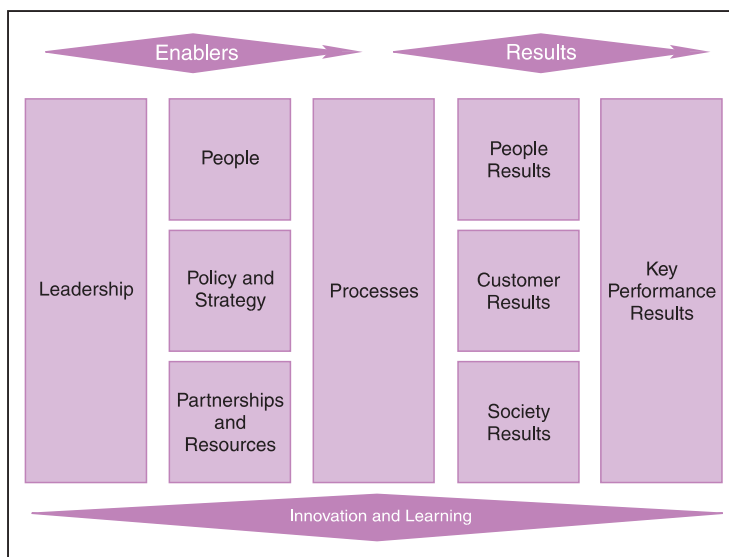
Costco keeps its labour costs lower than Walmart's as a percentage of sales and its workers sell more per square foot of store space. Costco earned \$13,647 in operating profit per employee in 2003, compared with \$11,039 at Walmart. This is a by no means isolated example of the way in which a progressive approach to managing people can boost business performance.⁵

The starting point is for companies to identify the drivers of their particular business success. These will vary by industry sector and company.

'The starting point is for companies to identify the drivers of their particular business success.'

The EFQM Excellence Model, introduced in 1992, provides a useful framework for companies to identify and manage their particular approach to achieving sustainable excellence in all aspects of performance. It is based on the premise that 'excellent results with respect to Performance, Customers, People and Society are achieved through Leadership driving Policy and Strategy that is delivered through People, Partnerships and Resources and Processes'.⁶

The EFQM Excellence Model



Measurement

Whilst the importance of non-financial drivers is well understood, they are often hard to measure. Companies have not found it easy to design and implement management information systems which effectively integrate into the management of the business the different performance indicators and measures which relate to these drivers. Managers have also found difficulty in relating non-financial indicators and measures to the tried and tested financial ones. The more recent developments in this area have therefore sought to achieve a framework or methodology that not only measures the right things but integrates them in a way that actively supports management decisions.

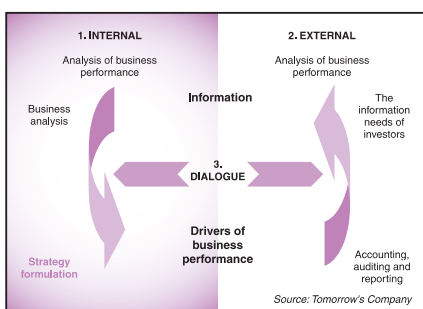
'Whilst the importance of non-financial drivers is well understood, they are often hard to measure.'

The development of these more diverse multi-factor measurement systems has its origins in the quality movement of the 1980s with its associated initiatives, such as the EFQM excellence model (above) or the Malcolm Baldrige award. These encouraged organisations to examine the 'softer' dimensions of their performance such as leadership, employees and impact on society. Business results – expressed in financial terms – still mattered but were to be considered in a wider context of interaction with the various stakeholders.

During the 1990s, a number of more holistic models were developed. Amongst the better known frameworks were:

- * **'The Balanced Scorecard'** – developed by the Nolan Norton Group which provided a framework for integrating financial measures with the drivers of business performance encompassing customer, internal-business process and growth perspectives.⁷
- * **The RSA work on Tomorrow's Company** – which developed an inclusive framework aimed at measuring leadership, key relationships with customers, suppliers, employees, and the community as well as the shareholder.⁸ This is described more fully in Appendix 10.

A more recent methodology is 'The Performance Prism' developed by Neely, Adams and Kennerley. This framework seeks to integrate five related themes – stakeholder satisfaction, stakeholder contribution, strategies, process and capabilities.⁹ This is also described more fully in Appendix 10.



Strategy formulation

A company's strategy is designed to achieve sustainable competitive advantage – i.e. a position in the market which enables the company not only to earn a higher profit margin than its competitors, but allows it to sustain that position over a significant period.

In the world of the 21st century that 'significant period' may be quite short - particularly in those industries associated with rapid technological developments. The implication is that the frequency of review depends on the speed of change characteristic of the market.

Strategy is a highly complex concept and attempts to describe a company's strategy within the compass of a sentence or two are almost certainly going to fall short. The following are the issues that need to be taken into account:

- * **The company's definition of its purpose or mission** – in effect, a statement of why the company exists.
- * **Policies** – these are guiding rules or principles that are regarded as an integral part of the company's 'success model'; they are practices or ways of doing things, often long-established, that are seen as indispensable parts of the company's formula for achieving a sustainable competitive advantage.
- * **Defining what business the company is in, or is to be in and what kind of company it is, or is to be** – corporate purpose and company policies are closely linked to these two key strategic decisions. The first is to do with choice of industry or industries in which to operate and which sectors or niches within broad industry groups to focus on, recognising that there is an interaction between the attractiveness of a particular market sector and a company's ability to compete in it. A company can be the best competitor, but if the market is unattractive then it still may be unable to create value. The second is to do with the difficult and intangible area of corporate culture.

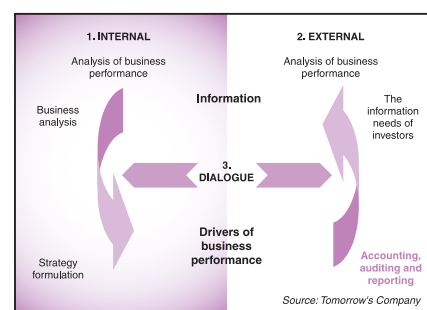
- * **Specific objectives or goals** – these terms tend to be used interchangeably. Strategic objectives are normally ones to be achieved over the medium to long term. They may be financial such as an increase in earnings per share or non-financial such as a percentage increase in market share. In theory they should be quantifiable and hence susceptible to measurement.
- * **Strengths and weaknesses** – identifying what the company does well; what differentiates it from its competitors; what it does badly and could be improved and what it should avoid.
- * **Opportunities and threats** – identifying opportunities in the market place and matching them with the company's capabilities, at the same time as scanning the environment for potential threats to the competitiveness of the business are important parts of the strategic process.
- * **Key success factors** – these are the areas where a business must excel if it is to attain a leading position in a particular market.
- * **Capabilities or core competences** – these are the bundles of skills and technologies that enable a company to provide a particular benefit to customers.
- * **Key decisions** – these are of fundamental importance to the business, but may not prove to have been right or wrong for some considerable time. For example, the decision to make an acquisition of another company will normally take at least two to three years before its soundness can be assessed. Strategic decisions are normally irreversible or at least can only be overturned at considerable cost.
- * **Planning, scheduling and implementation** – a sound strategy starts with planning and scheduling. It calls for decisions about organisational structure, the allocation of resources, and the acceptable level of risk. It also involves leadership and managerial skills, particularly when, as is often the case, major organisational change ensues.¹⁰

2. External analysis of business performance

Accounting, auditing and reporting

Financial reporting provides audited accounts to standards required by company law and national or international accounting standards. This provides evidence to shareholders of management's stewardship of the company and serves as the basis for levying corporation tax.

When auditors sign off a company report it is therefore reasonable to expect that the company is a viable concern for the foreseeable future. However, highly visible examples of fraud and cases of long, but undetected managerial incompetence, combined with evidence of conflicting pressures on auditors, (as already discussed in 'Alignment and transparency' Page 56) as well as a number of critical reports by the accounting profession and others, raise serious questions about the robustness of current financial reporting. This needs to change if the confidence essential to the effective functioning of the financial markets is to be improved.



'...raise serious questions about the robustness of current financial reporting.'

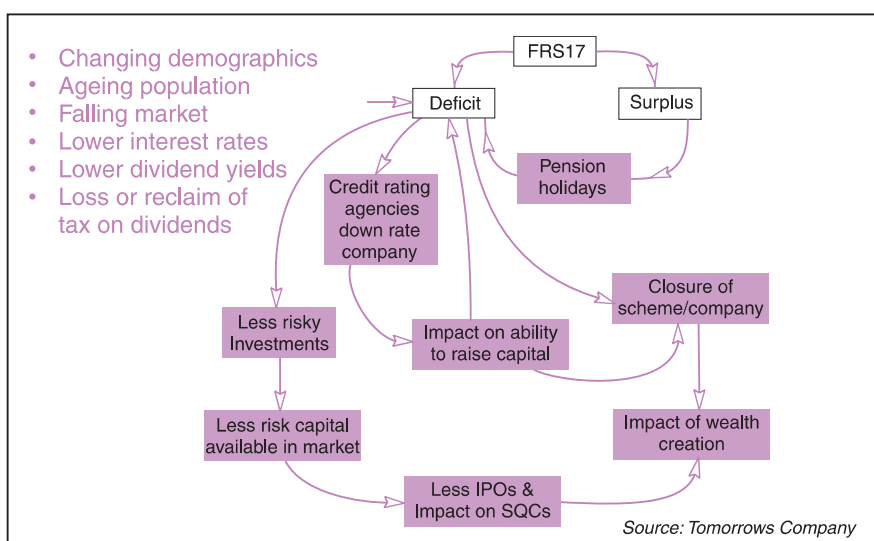
To improve the credibility of financial reporting, action will be necessary at all points along the information supply chain that delivers financial reporting to the market. Corporate managements and boards of directors, who have the prime responsibility for financial reporting, as well as auditors, standard setters, regulators and other participants in the reporting process such as lawyers, investment bankers, analysts and crediting rating agencies, all have important roles to play and improvements in practices to make to restore the credibility of financial reporting. *International Federation of Accountants.*¹⁷

This confidence can in part be restored by encouraging the inclusion of a wider range of factors in auditing and reporting verification requirements indicative of a company's health. For example:

- * *the effectiveness of risk assessment and management – this is becoming increasingly important in the light of Sarbanes-Oxley and the Combined Code on Corporate Governance.*¹²
- * *corporate governance structure and practices*
- * *investment in people*
- * *quality and continuity of leadership.*

Yet, as already discussed many of these fall into the non-financial area and are often viewed as secondary considerations as opposed to being central to the performance of the business.

A case in point was Marks and Spencers during the late 1990s. Profits were high but changes in customer attitudes, the views of the fashion media, decline in staff morale and product quality should have provided ample early warning of a potential future drop in earnings – but these signals were ignored in favour of a focus on current profitability.



Accounting requirements have also been blamed for having unintended consequences. An example is FRS17 requiring full disclosure of pension fund liabilities:

- * *It has been criticised for creating a misleading 'snapshot' approach to long term pension fund liabilities and may well have contributed to the decision to close some defined benefit schemes*
- * *In some cases the disclosed liability has been a contributory factor in the downgrading of credit risks impacting on a company's ability to raise capital.*
- * *The International Accounting Standards Board has proposed a new accounting standard to come into force in January 2006 (IAS 19) under which firms can either register scheme losses or gains immediately in their profit and loss accounts, or spread the cost over the service lives of their employees.*

Developments in standards and practices

There are ongoing developments to improve the quality of financial reporting and the audit function, in the use of non-financial information by the auditing profession, in the regulatory framework and by companies:

- * **The setting of standards has now become an international activity** – the EU Commission has recommended that all EU listed companies prepare their consolidated financial statements in accordance with International Financial Reporting Standards by 2005.
- * **The establishment of the Financial Reporting Council (FRC) as the new, single, independent regulator** – to oversee accounting and auditing with the roles of:
 - Setting accounting and auditing standards
 - Proactively enforcing and monitoring them
 - Overseeing the self-regulatory professional bodies.¹⁴
- * **The ICAEW has launched an ‘Information for Better Markets campaign’** – to explore the key underlying issues in business reporting and to promote dialogue and research. Its report on ‘New Reporting Models for Business’ looked at some of the most important reform proposals of recent years.¹⁵
- * **Auditing** – the right of shareholders to elect auditors at the AGM is usually a formality. Recently major UK companies have been required to strengthen the powers of their audit committee to review the performance of the auditors and propose a competitive tender for the role where they feel it is appropriate. Audit committees are also setting limits on the nature and quantum of fees that audit firms can earn from non audit services. Much of this momentum has come from the USA in the post Enron environment but legal and regulatory change is following through its own agenda strongly in the UK. The various recommendations regarding the independence of auditors put forward by the Co-ordinating Group on Audit and Accounting Issues (CGAAI) are now being taken forward or being implemented through the current Companies Bill.
- * **International Federation of Accountants (IFAC)** – is the global organisation for the accountancy profession. It issues guidance on auditing, assurance, related services and quality control; education; ethics; information technology; professional accountants in business; and public sector accounting. Following an extensive consultation during 2003, IFAC reviewed its governance activities and regulatory responsibilities resulting in a series of reform proposals that IFAC views as critical to strengthening the accountability of the international profession and building investor confidence in financial reporting, in the work of auditors, and in financial securities markets worldwide. One particular recommendation is that:
 - Codes of conduct be developed covering the standards that should apply to the activities of financial analysts, the provision of advice by lawyers to clients on matters relevant to financial reporting, and, similarly, covering the advice given to companies by investment banks. These codes should be made public and should be monitored both within the firms and externally. It is also recommended that where lawyers take a position of advocacy, the advice should include a summary of the significant issues raised so that the board is in a position to evaluate the advice. Additionally, credit-rating agencies should be required to disclose their criteria, their evaluation processes and the quality control mechanisms that they use.¹⁷

The Institute recognised some years ago the limitations of traditional financial statements as a source of information for investors seeking to make rational economic decisions. Annual reports and financial statements tend to have a historical perspective and provide limited information about strategic strength or other future-oriented matters. We believe that corporate reporting should provide users with more forward-looking information and more information about intangible assets and other drivers of shareholder value. We therefore recommend that a wide-ranging OFR with due emphasis on risk-related information should be a key component of companies’ annual reports.

Institute of Chartered Accountants in England and Wales, (ICAEW),¹³

The collapse of Enron and WorldCom – and the accountancy malpractice they revealed – appalled investors all over the world. We owe it to savers, investors and employees as well as honest business people to ensure that our defences are as robust as they sensibly can be.

Patricia Hewitt.¹⁶

Our prime area of expertise is the management of people and we have produced a number of research studies to show the powerful impact of people and how they are managed on the long-term success and sustainability of organisations. The OFR represents a great opportunity to improve the forward-looking nature of annual report and accounts in the UK, and particularly the amount and quality of information on an organisation's most important asset: its people. This is sadly deficient under current reporting arrangements. The OFR is an appropriate vehicle in which to address this shortfall, and to provide more and more effective information on how a company's people are managed so as to deliver added value and competitive advantage.

Duncan Brown,
CIPD Assistant Director General. CIPD¹⁹

* **Developments in the Operating and Financial Review** - the purpose of the OFR as conceived by the Accounting Standards Board in the early 1990s was for boards of directors to give a straightforward account of their company's past performance and likely prospects. The Company Law Review introduced the concept of a statutory OFR, for companies over a certain size threshold. The Sooner Sharper Simpler framework developed by Tomorrow's Company was used by the Company Law Review and has become the foundation of the new OFR.¹⁸ The OFR must cover all the principal issues, both financial and non-financial, that may impact on a company's future prospects. The DTI White paper on the subject makes it clear that it will be for directors to decide precisely what information is material to their particular business and thus should be published in the OFR. The government set up an independent 'Working Group on Materiality' to assist in the development of guidelines to support companies in the preparation of the OFR. Directors are advised in the guidelines that they need to start with the purpose and values that drive their business, to take a broad view of the use that will be made of the OFR, and strike a proper balance between an historical review and a focus on the future. They will have to go beyond those factors that can be measured, and ensure that their reporting is consistent from year to year.

The implications of this are that directors now need to develop an integrated measurement framework, based on a rigorous assessment of all the factors that drive success and help the company to maintain its competitive position. Because directors will be required by law to sign off on the thoroughness of this process, this is likely to lead to a change in the balance of the boardroom agenda. Much more time will need to be spent on discussing and understanding the leading indicators of tomorrow's performance. It will no longer be possible to relegate questions about corporate values, customer perception, or employee commitment to the social report: these intangible but essential constituents of future financial performance will have to be analysed and reported on as part of the mainstream governance of the business. Equally it will not be good enough to accept someone else's framework: the onus is on the board to work out what makes their business unique and to select the appropriate measurements which tell its story. This should then provide a much better platform for an informed dialogue with investors and other stakeholders about where the business has come from and where it is going.

* **ValueReporting® Framework** – developed by PricewaterhouseCoopers. This encourages companies to provide a more detailed, transparent picture of their performance and advocates the construction of a business model that identifies quantified relationships between indices of value drivers (such as product and service quality, employee competence, employee motivation, delivery performance and customer satisfaction) and shareholder value, via financial measures such as sales value.

Guidelines have also been developed by other interested parties, particularly in the area of social and sustainable reporting. For example:

- * **The Global Reporting Initiative's Sustainability Reporting Guidelines** - represent the most comprehensive global framework for sustainability reporting, encompassing the 'triple bottom line' of economic, environmental, and social issues. The Guidelines bring reporters and report users alike one major step closer to elevating sustainability reporting to a level expected of financial reporting.²⁰
- * **AA 1000 Assurance Standard for sustainability reporting** - launched in 1999, the AA1000 framework is an accountability standard designed to improve accountability and performance by learning through stakeholder engagement. It was developed to address the need for organisations to integrate their stakeholder engagement processes into daily activities.²¹

Developments by companies

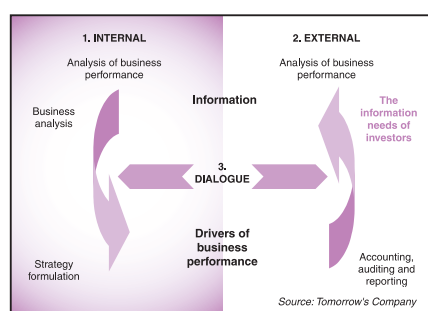
Some of the companies which have led the field in terms of reporting practices are:

- * **BT** – the largest company to date to apply the new AA1000 Assurance Standard for sustainability reporting.
- * **The PricewaterhouseCoopers Building Public Trust Awards**²³ – focus on the quality of the reporting of the largest 350 companies in the UK and their public commitment to building public trust through their willingness to embrace greater corporate transparency. The winner of the Building Public Trust Award 'for telling it how it is' was **Geest PLC** which was praised for: its good qualitative analysis of markets, strategy, value-creating activities, and financial performance; its market overview and having the most aligned report, i.e. mirroring internal reporting. Awards in the other four categories of corporate transparency went to **Land Securities Group PLC** (communication of corporate strategy), **Tomkins plc** (reporting of economic performance), **Reuters Group PLC** (reporting of executive remuneration) and **British American Tobacco plc** (stakeholder communication).
- * **Investor Relations Best Practice Website Awards**²⁴ - initiated in 2000 by the London Stock Exchange and the Investor Relations Society and supported by the Department of Trade and Industry's Future and Innovation Unit, the awards encourage greater use of internet technology to provide all investors with the information they need in easily accessible form. The winners of the 2004 awards were **Cadbury Schweppes plc** (Grand Prix IR Best Practice Award for Best Overall Website and IR Best Practice Website FTSE 100 Award); **Signet Group plc** (IR Best Practice Website FTSE 250 Award), **Kingston Communications plc** (IR Best Practice Website Smaller Quoted Company Award), **Reuters Group plc** (IR Best Practice Website Professional Investor Award); **Benetton** (IR Best Practice Website European Award), **BAT plc** (IR Best Practice Website Private Investor Award) and **Friends Provident plc** (IR Best Practice Website Most Improved IR Website Award).

The FastForward Research 2002 commissioned by Business in the Community showed that European senior business leaders realise more than ever that responsible business practice enhances creativity and could significantly improve profitability. It also highlighted the need for an integrated approach to the management of environmental, social and economic issues - 78% of respondents believed that competitiveness would only be increased if responsible business practice was integrated throughout the organisation. The need for an integrated approach is also emphasised by investors and analysts. Over half of the analysts and investors, (both mainstream and those marketing socially responsible investment funds) interviewed during Business in the Environment's 'Investing in the Future' research into City attitudes to environmental and social issues [Source: MORI/Business in the Community, May 2001], indicated that an integrated approach is important. This compares with just one third who are interested in information on environmental or social policies of companies presented in isolation. They want companies to integrate reporting on strategy, risk management and performance, covering financial, environmental and social issues.²²

‘Further integration is needed between all the various aspects relevant to a company’s performance.’

Whilst these developments in accounting, auditing and reporting are a positive move forward, there is often a tendency to consider different aspects of a company’s performance in separate compartments. Social, environmental and sustainability reporting are often separated from the main body of information reported. Additionally, without a full understanding of the purpose behind these initiatives many of the options being brought forward may encourage a ‘box ticking’ approach to addressing these issues. Further integration is needed between all the various aspects relevant to a company’s performance into a single reporting model based on guidelines and conceptual frameworks which enable a company to reflect its own uniqueness and drivers of performance. This is where the work on OFR is particularly beneficial.



The information needs of investors

It is recognised that some investment decisions are based purely on market sentiment, often reinforced by herd-like behaviour. However, many are based on analysis of information.

Financial information, for the purposes of investment decision-making, performs two functions. On the one hand it establishes the company’s historical track record – return on invested capital, added value created, cash flow etc.– on the other, it provides a basis for assessing a company’s prospects going forward – at least in part a function of its financial capability in areas such as cash generation.

It is important to identify the intrinsic value of a business. This is derived from the value of its future cash flows and from its perceived value - which in the case of a quoted company is based on the share price. Discussions about shareholder value often only deal with changes in share prices without giving due consideration to whether the intrinsic value of a business has also changed. Failing to look at both aspects can lead to mis-valuation and dramatic losses of apparent shareholder value.

The interests of long term investors are best served when emphasis is on the sustainability of cash flows, but in practice attention is often focused on the immediate future and the likely effect of short-term factors on business prospects. In addition, the strength of any valuation is curtailed by constraints on the release of prospective financial information by directors. This leaves investors having to project forward values on the basis of directors’ statements of past performance.

The boom in technology stocks in the late 1990’s was partly fuelled by some wildly optimistic assumptions about future cash flows, often using EBITDA as a key indicator and leading to absurd PE ratios. The PricewaterhouseCoopers ValueReporting® Framework emphasises the greater relevance of a range of financial metrics. For example.

- * *economic profit or economic value added*
- * *cash flow return on investment (CFROI)*
- * *total shareholder return.*

In the same way that companies need to continue to extend their understanding of what constitutes business success, so the investment community needs to strengthen the models used for company analysis.

Studies in both the US and the UK have shown that analysts use non-financial data in their decision making and that 35-40% of portfolio allocation is based on non financial information. A study by Ernst and Young has demonstrated that analysts pay particular attention to internal and employee-related factors such as efficiency, empowerment, incentive compensation, and innovation-related factors such as training, research and development, and product development.²⁵

Although investors are more likely to take account of qualitative non-financial information if that information is credible and economically relevant, a real issue with disclosure at present is that because intangible resource metrics are often difficult to define, and even more difficult to measure, many practitioners are satisfied if they have something to report and are not concerned about the quality of the data. A recent Brookings Institution Project, looking at the role of intangibles in the economy, concluded that although markets need improved information disclosure managers have no incentive to improve the information about their intangible resources.²⁶

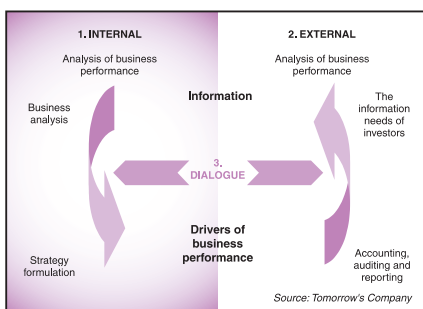
Some parts of the investment community have also developed alternative models which help extend the analysis of companies beyond the financials, particularly in areas such as corporate responsibility. Examples are: CoreRatings a leading European rating agency, providing independent investment analysis of corporate responsibility risks and the GovernancePlus Service, provided by PIRC whose reports include analysis of environmental, human capital, human rights and community investment issues in terms of key criteria related to corporate policies, reporting, management and impacts.

The ability to take a long-term view is also linked to the question of measurement, and the way that the industry defines risk. Many professionals throughout the investment chain fall into the trap of one-dimensional risk assessment. This one-dimensional approach proved damaging during the rise and fall of technology stocks. In the absence of a methodology that enabled investors to assess the quality of management and leadership of investee companies, many bets were made on the sector business model and prospects, rather than on the ability of a particular team to make a success of their company.

'...parts of the investment community have also developed alternative models...'

A survey published by CSR Europe, Deloitte and Euronext reveals that social and environmental performance is on course to become a significant aspect of mainstream investment decisions within the next three years. The survey, Investing in Responsible Business, shows that a majority (52%) of fund managers and analysts and 47% of investor relations officers (IROs) agree that this trend will soon become a reality.

The survey also concludes that the financial community sees a direct link between non-financial risks and shareholder value: eight out of ten fund managers and analysts believe that the management of social and environmental risks has a positive impact on a company's market value in the long-term. The view is echoed by the companies themselves: IROs think that good social and environmental performance in the long term influences a company's brand and reputation (69%), economic performance (46%), and market value (36%).²⁷



'Share prices are not just the outcome of the facts available about a company but also the judgments and interpretations of many people who have incomplete information.'

3. The dialogue

Investment objectives need to be built on a realistic assessment of the prospects of the companies in which they invest.

Share prices are not just the outcome of the facts available about a company but also the judgments and interpretations of many people who have incomplete information. These judgements will have some grounding not only in the experience of the individual concerned but also in the assumptions he or she makes about the company, its sector, the economy and so on.

Companies are often reluctant to communicate their purpose, strategy and objectives in detail. This can hinder an alignment of their investment needs with those of their investors. Companies need to manage effectively the relationship with their existing investors, certainly if they wish to attract and retain a particular type.

The investment community may be fine in terms of the discussions that take place in a trading room but I wouldn't like to have a detailed strategic discussion with them. There are different sorts of people responsible for strategy that you wouldn't necessarily talk to. Managing these people is a huge issue central to share performance, but you can't talk to them normally. At board level you need to have complex dialogues about strategy.

I have rarely met anyone in the investment community who has managed anything of any size. When you get to the guts of the business, there are difficult discussions that need to be made. What you tend to get are the contours of public debate e.g. remuneration

If you tried to run a company according to what shareholders want – it would be madness. You cannot run a public company that way. You need to state what you are going to do and hope and expect the market mechanism will find investors who want what you offer.

Companies are getting fed up with numerous questionnaires etc. Companies need to take a proactive stance and make it known what they are doing well, how are they are managing different risks. Companies are currently waiting for the next step – they should move towards being more market driven rather than agenda driven (e.g. Don't worry about talking about the use of child labour if it's not used). Should encourage companies to be more pro-active rather than reactive

Expectation management is a very important part of Investor Relations. Both the company and the market are involved. The overall flow of information must remain calm and controlled. That's essential for both to get the best out of the relationship. It's a two-way process.

Some companies are arrogant and considered a higher risk because they don't interact openly with analysts. *Quotes from consultation workshops*

Valuation

The flow and exchange of information is vital as the lack of relevant and accurate data can result in a company being either under or over valued. In 2002, Mark Scott, of the Ashridge Strategic Management Centre, began an ongoing process of research into the causes and consequences of mis-valuation.²⁸ His preliminary findings are that:

- * *There are a number of more specific forces in the market which are likely to create and sustain situations of mis-valuation. One such force is the role of the sell-side analyst – the evidence suggests that sell-side analysts over rate growth stocks and under rate low growth stocks.*
- * *Institutional investors using active investment strategies are unlikely to act early to correct premiums or take advantage of discounts. Fund management companies are measured annually against the FTSE All Share Index or relevant fund peer groups. Individual fund managers are incentivised on this basis and exhibit extreme reluctance to risk falling below the index. As a result, there is a reluctance to sell down a high premium stock until it has begun to slide and re-weight, compelling them to follow.*
- * *Deep disclosure may be a precursor to fair value and that the company's value story is a critical driver of active investor support. Companies that had bounced back from undervaluation appeared to have espoused a philosophy of deep disclosure, often following a strategy of corporate restructuring, and deepening exposure to divisional performance and allowing analyst access to divisional management. Although it would seem logical that deeper disclosure would lead to more accurate valuation, it became clear from interviews that many companies regard disclosure with profound suspicion. It was seen as a threat to management flexibility and the disclosure requirements imposed by the FSA were regarded as increasingly onerous.*
- * *the philosophy of 'value reporting', which primarily focuses on the disclosure of non-financial as well as financial operating data, had not yet been widely adopted by the companies interviewed. The ability of the company to communicate clear, meaningful drivers of longer term value was critical to re-valuation. The ability of the fund manager quickly to distil the value story of the company and relate it to their monitoring criteria will influence their willingness to invest actively in the company. Re-rated companies appear to both successfully articulate longer term sources of value, as well as having systematically lowered expectations for short term results.*

These findings suggest that there is some evidence of a systematic bias towards mis-valuation. The research also implies that the markets respond with excessive optimism to data pointing to growth and with undue negativism to data pointing towards stagnation. The result is a bias towards large premiums in periods of company growth and then discounts in periods of relative stagnation.

Once floated, the availability of finance for SMEs is also affected by limited institutional interest. Larger institutions may find it efficient to deal only in companies that are above a certain value. Below this threshold, companies are not on the radar screen – even the FTSE All-share index only covers approximately 30% of listed companies – as the costs to the institution or market maker of researching the company may outweigh the returns available. This constrains liquidity and increases the perceived risk of investing in these companies and returns required.

Recent research demonstrates a clear linkage between market capitalisation and research coverage and indicates the impact of this on valuation and liquidity. While many analysts cover the large stocks – some have forecasts from more than thirty analysts – the researchers found no published forecasts for more than 450 stocks. It was calculated that the aggregate loss to profitable companies through the lack of independent research is in the order of £8 billion. Neglected companies have lower valuations and liquidities, which impair their ability to raise capital, to issue shares when making an acquisition or to defend themselves against takeover bids. Also, shareholders in neglected companies are likely to receive 5% less than the mid-market price when selling and that in turn may be 20% to 30% less than the mid-market price of a similar stock that has good research coverage.²⁹

Impact of the media

Although the news and business media are not formally a part of the investment system, they have a crucial part to play. They provide the potential for transparency which is essential to the proper functioning of the corporate and financial services system. They also play a vital part in educating and informing investors. There is, not surprisingly, a big gap between the best and the worst. For example retail financial journalists score well in consumer surveys, better than other experts.

It would be inappropriate to seek further formal regulation of the press. Indeed, there is a case for increasing press freedom by easing Britain's onerous libel laws to be more like America's. Action by government, or by regulators such as the FSA in the Interbrew case, that discourages journalists from publishing information about firms that they believe to be true, or to reveal their sources, is unlikely to foster transparency.

Even so, there is a case for better self-regulation by media companies and industry-wide bodies.

There have been very few reported examples in the UK of financial journalists abusing their position of influence for personal gain. Such behaviour is governed by industry self-regulation. Clause 14 of the Press Complaints Commission Code of Practice requires that:

- i) Even where the law does not prohibit it, journalists must not use for their own profit financial information they receive in advance of its general publication, nor should they pass such information to others.
- ii) They must not write about shares or securities in whose performance they know that they or their close families have a significant financial interest without disclosing the interest to the editor or financial editor.
- iii) They must not buy or sell, either directly or through nominees or agents, shares or securities about which they have written recently or about which they intend to write in the near future.³⁰

Financial journalists may occasionally be compromised by accepting corporate hospitality and other gifts, participating on paid-for press trips, accepting free flights and accommodation, speaking fees, freelance and consulting work, etc.

Much harder to remedy is a broader problem addressed by Dame Marjorie Scardino, the chief executive of Pearson, owner of the Financial Times. She asked why the media had failed to uncover sooner such scandals as the accounting fraud at Enron. Though she may have gone too far in blaming journalists for their insufficient skill at reading balance sheets and their obsession with the personalities of chief executives, media organisations could do more to ensure that their reporters have sufficient experience and understanding to cover accurately the firms they report upon.

The media sometimes obtain their material from fund managers who are happy to brief them anonymously, and then see their comments published unattributed. Sometimes it is hard to tell who is manipulating whom, but it might be helpful if a journalist offered such comments were to ask the source whether they had confronted the company direct with the criticisms that they now wanted to see in the public domain.

Journalists in general are routinely accused of sensationalising, trivialising or personalising stories. But if they are to produce more thoughtful material about the drivers of long term value, then much of the initiative needs to come from companies. If, as is recommended elsewhere in this section, companies do begin to set out their approach in a more strategic way, then the challenge for the business and financial media will be to reciprocate with more frequent and forward-looking coverage of these strategies.

Impact of technology

Technology offers the possibility not only of streamlining the delivery of information to investors but also increasing its availability to a wider audience. This can help strengthen the quality and range of debate between investors and companies. We have already touched on the possibility of using web-casts to increase access to AGMs. The need for more information of known quality will require more innovative delivery systems.

One development which is assisting dissemination is the new electronic language for financial data Extensible Business Reporting Language (XBRL)³¹. It provides major benefits in the preparation, analysis and communication of business information. It offers cost savings, greater efficiency and improved accuracy and reliability to all those involved in supplying or using financial data. It is being developed by an international non-profit consortium of about 250 major companies, organisations and government agencies and is already being put to practical use in a number of countries, including the UK.

The Financial Services Authority has joined XBRL UK and will use the XBRL reporting language from 2005 when it begins to collect firms' regulatory returns electronically. The FSA expects that some firms will choose to use XBRL compliant software to allow the provision of data directly from reporting systems to the regulator.

XBRL-UK is also working in close cooperation with the International Accounting Standards Board (IASB) on plans for the introduction of XBRL and formats.

Agenda for change

The provision of information to the markets and the current dialogue between companies and those investors and analysts who have an inherent interest in the long term, sustainable performance of companies needs to be as informed and comprehensive as possible. This dialogue needs to take into account the uniqueness of the company being evaluated and encompass as wide a range of factors as possible covering both financial and non-financial criteria.

Barriers that potentially interfere with the provision of accurate, reliable information and the improvement of this dialogue need to be addressed. These include the short-term culture and mindset that is prevalent in the City, often reinforced by the nature and structure of incentives; the lack of knowledge and use of measurement frameworks which show the importance and interdependence between financial and non-financial indicators of performance; and the impact of changes in reporting requirements, which are creating complexity as well as having the unintended consequence of reducing the availability of information as international integration is sought.

Our proposals

In the area of knowledge and understanding – we propose:

- * *That all parties in the system should:*
 - *acquire a better understanding of, and use the body of knowledge about all the indicators which inform the long term future performance of companies; and*
 - *collaborate in the development of enhanced evaluation frameworks, standard metrics and a common language particularly in the area of risk.*
- * *Professional and management education and qualifications should be reviewed to include an appreciation of and greater emphasis on the wider range of metrics available and the dynamics of the system as a whole.*

In the area of research – we propose:

- * *Independence of research should be reinforced to enhance the quality of information provided - analysts' reports should include quoted verifiable sources independent of the company.*

'Barriers that potentially interfere with the provision of accurate, reliable information...need to be addressed..'

All investment houses have their own cultures and ways in which they measure the 'softer' issues. If you are asking whether there are any fundamental generally accepted criteria – I think the answer is no. There is a commonly accepted language developing around the kind of issues which should be looked at but there will be subjectivity.

The industry should make a concerted effort to innovate – find a common language that is wider than the term mainstream.

Quotes from consultation workshops

The same competence issue applies to SRI analysts – there is no training or certification. Many come from the NGO community. Not all are good enough, but they still get taken at face value.

Quote from consultation workshops

There is some criticism that analysts are just company mouthpieces. However another conflict is that a negative report can damage your relationship with the company you are reporting on and future access to that company – hence influencing your effectiveness as an analyst. Important to burrow deeper into the company's activities rather than look at the forecasts e.g. look at the containers at the port, the inventory position etc – this is dynamite research and is not done enough by analysts. This kind of deep level research is worth a lot to institutional investors but it is expensive. The other issue is who pays - the plan sponsor? – the pension fund/beneficiary? (this raises the question of incentives and alignment), the fund manager? – (unlikely given that they are feeling the squeeze on costs). So good research is desirable but is being squeezed by cost pressures.

Quotes from consultation workshops

There is also the problem that the average length of reports is going up not down – they're getting thicker and thicker. Part of the reason is the differences between US and UK GAAP and SORGAT. A 32-page review is different, even though much is prescribed. The balance of regulation is an issue - should there be more prescription and regulation or more professionalism?

Annual reports are difficult – the back end is getting bigger and bigger. A large chunk of the report is devoted to corporate governance, social and environmental issues but often as a box ticking exercise. There are things an investor should want to know, but the 'should know' information is hard to find among all the statutory requirements.

Quotes from consultation workshops

Shared objectives are very important – this also applies to those investing in companies and as a CEO I want to understand who is investing in me and as an investor I want to know if the company I am investing in has different objectives to me.

Quotes from consultation workshops

- * *Institutional investors should ensure that their own research processes and methodologies take into full consideration those of the leading academic centres that focus on business performance analysis and measurement.*
- * *Evaluation be extended to cover a wider range of companies.*

In the area of accounting and reporting – we propose:

- * *Standard setters and professional bodies should consider the following for the future accounting and reporting for companies:*
 - *Companies should be allowed to present 'forward looking' information, such as their assumptions about the future of their markets or prospective financial information akin to that currently seen in house brokers' reports. This is likely to broaden the dialogue between companies and investors, increase director accountability and give a more comprehensive picture of the company's potential performance. The new statutory OFR provides an opportunity to do this.*
 - *Greater attention should be paid to non-financial data and to indicators of long-term performance.*
 - *Accounting standards should be supplemented with information that provides greater transparency regarding future cash flows. (The proposed new IASB Standard referred to on page 82 addresses this point.)*
 - *The potential to simplify the accounting and reporting model should be examined – e.g. the need to reconcile information to US GAAP is leading to the lack of disclosure by companies of information that would be valuable to investors.*

In the area of dialogue – we propose:

Companies should initiate a much deeper and more strategic dialogue with investors and be bolder in setting out their long-term strategy. This could be achieved through:

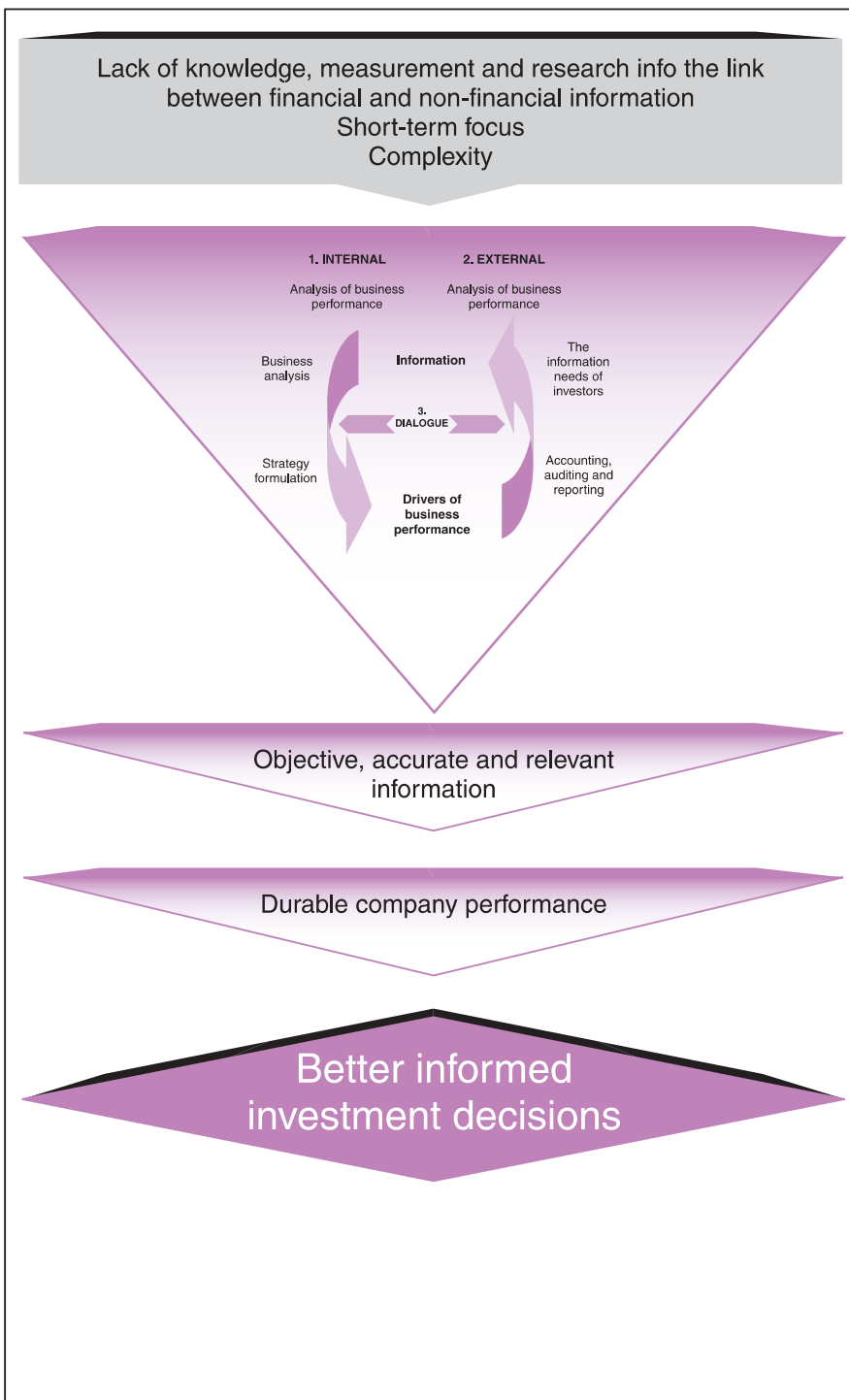
- * *Issuing statements which outline the long term strategy of the company. The OFR provides a useful starting point. Whenever major changes in strategy are proposed these should be clearly submitted to investors for challenge and debate. These could be followed through in company reports. Over time the bravest companies might put these statements to the vote.*
- * *Creating a dedicated space within the AGM or holding a 'strategy conference', in addition to the AGM, once every two or three years, reserved for the institutional investors and intermediaries selected by individual shareholders to act on their behalf, at which strategy and future plans could be explored and tested in far more depth than is customary at routine investor presentations. Discussions could also be made available to private investors through the use of web casts.*
- * *Companies should also be obliged to publish any decision to exclude or disadvantage an analyst who has provided unfavourable comment, in order to safeguard independence of judgement by investment analysts.*

In the area of the media – we propose:

* Media organisations should affirm and apply their commitment to the Press Complaints Commission Code of Practice. They should also publish their policy on areas of potential conflict of interest for financial journalists and have a system in place to ensure compliance.

Trust and integrity – evaluating long-term business success

Putting it all together



Key Area for Change 5 - the individual investor

'Trust no one' is the message. According to research, 59% of working adults with a personal pension lack confidence in their employer, the government and their pension company to keep their word on the pensions promise.¹

A survey by Royal Liver Assurance, using a 2,000 strong sample found that despite the stock market rally of the 12 months to March 2004 savers remain cautious about investing in shares. 72 per cent said they would be worried about losing all or part of their investment if they put money into the stock market with the aim of achieving growth over the next 5 years. Just 1 in 8 said they would be willing to take the risk and only 1 in 12 was confident the money would grow.

Royal Liver's conclusions support the findings of the House of Commons Treasury Select Committee that confidence in savings products has plummeted in recent years.²

William Kay

Introduction

This section focuses on retail financial products - endowment policies, unit trusts, Individual Savings Accounts (ISAs) and the like – also those forms of pension provision which involve risk being borne by the individual. A number of reviews have been undertaken or are being progressed in this area such as those by Sandler, Pickering, Penrose and Turner. These are summarised in Appendix 1.

An analysis of the recent history of individual investment in the UK reveals that three key trends have emerged:

- * *a decline in personal saving*
- * *a move away from state and company to personal provision for retirement, accompanied by a commensurate shift in the burden of risk*
- * *a loss of faith in financial institutions and companies which has aroused feelings of mistrust and anxiety.*

The decline in personal saving

Since the late 1990s there has been a surge of consumer confidence. This has been largely fuelled by sustained economic growth, a high level of employment and low interest rates. This has given rise to a growing willingness to take on debt to fund house purchase and to finance other consumer expenditure – the consequence of which has been a decline in personal savings.

Even with all the front page news about pensions and retirement, younger people starting careers still see retirement planning as a low financial priority with only a minority stating it as a main concern, according to analysis of market research carried out on Hewitt Bacon & Woodrow's behalf by Prospektus. Other needs such as lifestyle (59%) and family / health protection (62%) were classed as higher priorities.³

The move away from state and company to personal provision for retirement

Successive governments have sought to encourage individuals to make provision for their future and to reduce reliance on state provision. However, individuals' lack of confidence in the investment system and the increased emphasis on means testing of benefits has contributed to their reluctance to save. Ultimately this could be counter-productive and increase the burden on the state.

* *Governments have been shifting the burden of risk to the individual – many are not able to manage it:*

- *those on low incomes have been particularly affected by changes, such as the abandonment of State Earnings Related Pensions (SERPS) and the earnings-related guarantee*
- *many individuals do not have the necessary competence and skills to plan for their future*
- *the basis on which increases in the state pension are calculated has changed detrimentally both for existing and future pensioners.*

* *There are conflicting messages given. On the one hand individuals are urged to plan and save for the future, whilst on the other, the removal of tax relief on pension funds (ACT); reduction of tax breaks on ISAs and pensions and perpetuating means testing of benefits act to discourage savings by those on low and even middle incomes.*

* *The take-up of stakeholder funds, which were intended to be a product simplification to attract more people into long term saving, has been disappointing.*

The loss of faith in financial institutions and companies

Financial services

The loss of faith has flowed from:

- * *The retail financial services sector being plagued by a series of scandals. These are not accidents of history. They are systemic.*
- * *Providers offering complex products to individuals who often lack even the basic skills to understand them and the risks associated with them.*
- * *Distribution bias, as a result of commission payments or sales bonuses.*
- * *Changes to the corporate structure of the financial services industry following mergers and acquisitions and the opening up of new channels for banking and insurance products which have led to a blurring of the boundaries in the provision of financial products. For example, not only do Barclays create their own products, but they also market a range of products developed and managed by others. Sometimes this is explicit, such as the marketing of Legal and General's product range; at other times a brand name is retained, while outsourcing the operations. Furthermore, a proliferation of organisations, products and intermediary services, has heightened the complex nature of the industry.*
- * *Attempts to protect the individual investor and to tighten regulation which have added layers of extra cost and created complicated compliance documentation.*

In the period 2002/2003 – 39% of employed and 53% of self-employed men had no pension. This rises to 47% and 71% respectively for women.⁴

The facts are stark. On our current course the basic state pension in 2050 - when today's teenagers will be retiring - will be worth just 9 per cent of average earnings. People can no longer rely on occupational pension schemes as 75 per cent are now closed to new members. ABI research shows that approximately 8m workers are not saving at all for retirement and 2m not saving enough. Without action today we face a crisis in pension provision and an increasing tax burden tomorrow.⁵

Francis McGee,
Association of British Insurers.

'There are conflicting messages...'

Since April 2001, over 1.25 million stakeholder pensions have been sold and nearly 350,000 schemes designated by employers. However, the figures show:

- 82% of employer-designated schemes have no members;
- only 13% of employers are contributing to schemes and
- sales in the first half of 2003 are 15% down on the first half of 2002.⁶

Companies

The erosion of trust also extends to the perception of companies:

- * Many defined benefit schemes have been closed.
- * Many companies have taken the opportunity to reduce the level of their contributions to pensions for employees following the replacement of defined benefit schemes by defined contribution schemes.
- * Some companies are now not only closing their defined benefit schemes but also increasing executive remuneration packages and cutting back on contributions to defined contribution schemes for other employees.

Identifying the individual investor

There are four categories of individuals whose needs we address:

‘There are four categories of individuals whose needs we address.’

1. Members of occupational defined contribution pension schemes and other personal pension plans.
2. Those people who save for the medium to long term through one or more of the wide range of investment products on offer. These investors hope to build their savings to meet their needs and aspirations at a greater rate than may be obtained by leaving their cash on deposit. They are prepared to take a risk with their assets in order to achieve a superior return.
3. Savers who are risk averse and use interest-bearing cash deposit accounts with banks, building societies or National Savings & Investments products.

Households ¹ with different types of saving, 2000/01 ⁷											
Percentages ²											
	Accounts						Other savings				
	Current ³	Post Office	TESSA	ISA	Other bank/building society ⁴	Gilts or unit trusts	Stocks and shares	National Savings	Save As You Earn	Premium Bonds	PEPs
Great Britain	86	8	13	23	59	6	25	4	1	26	12
England	87	8	14	24	60	6	26	5	1	27	12
Wales	83	8	11	21	47	4	17	4	1	20	9
Scotland	78	5	9	18	48	5	20	3	1	16	9

1 Households in which at least one member has an account. See Notes and Definitions.
 2 As a percentage of all households.
 3 A current account may be either a bank account or a building society account.
 4 All bank/building society accounts excluding current accounts and TESSAs and ISAs plus other accounts yielding interest.

4. Finally, there are those who either do not save at all or do not save through retail financial products. These fall into three sub-groups:
 - * those who cannot afford to save
 - * those who can afford to save but who, for whatever reason, choose not to
 - * those who invest in a range of alternative investments, such as buy-to-let.

These last two sub-groups potentially represent an important market for the investment industry. Encouraging these better-off individuals to put money aside for medium and long-term financial needs (e.g. school/university fees and to be self-reliant in retirement) may not only be beneficial to them but important also for the long-term health of our economy.

People do shift categories over time – their needs and circumstances change as does their attitude towards and understanding of personal finance.

‘...needs and circumstances change...’

Research undertaken by MORI Market Dynamics broadly divided consumers’ attitudes towards finance into four groups based on the dimensions of confidence and knowledge:

Connoisseurs

More than six million (13%) of UK consumers are ‘Connoisseurs’ and this group is interested, confident and ‘savvy’ towards financial services markets. People in this group are more likely to be ABC1, aged 35-54, male and internet users. Less confident consumers are more likely to be DE, the youngest age groups and female. ‘Connoisseurs’ are likely to shop around for financial products and look at performance or rates rather than brand in financial services choice. ‘Connoisseurs’ are the group predicted to see the biggest growth in the coming years with a 27 per cent rise by 2008 to nearly eight million people. On this evidence it is apparent that people will in time heed the warnings and become more astute with their money.

Aspirers

More than one in five consumers (21%) aspire to financial sophistication but do not feel adequately knowledgeable. The ‘Aspirers’ are likely to strive to become more knowledgeable over time and this group is predicted to grow by 17 per cent making up almost 12 million of the UK adult population by 2008.

Head Buriers

Around half of all UK adults (25 million people) can be described as ‘Head Buriers’. This group are both disinterested in and lack knowledge and confidence about financial services. These are key targets for established brands as they look for reassurance from financial companies that they recognise. There is much inertia among people in this group and many have inadequate financial provision. However, the size of this group is predicted to diminish over the coming years by seven per cent to around 23 million.

Laissez – Faire

The ‘Laissez – Faire’ group are not that interested in financial services but are confident in their choices. They are likely to stick with a brand or supplier that they trust – often non-mainstream niche brands and suppliers. These are also a potentially good target market for independent financial advisers. The group, currently numbering around seven million UK adults, will remain roughly the same size over the forecast period.⁸

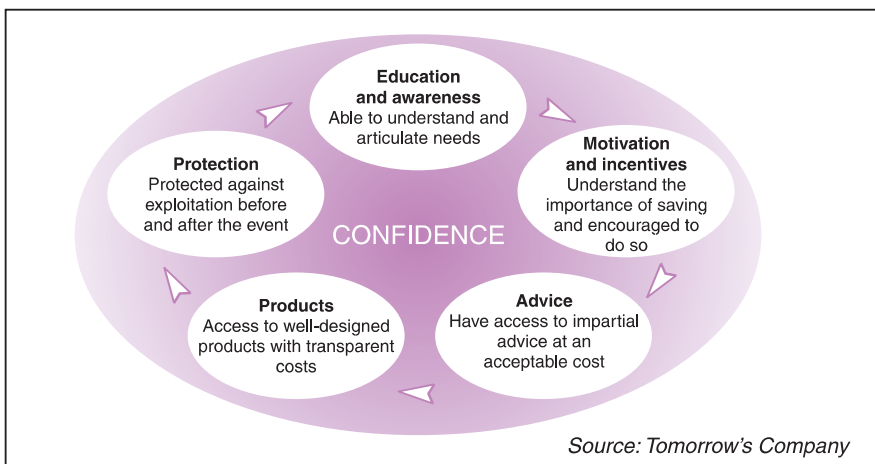
Conditions for a healthy retail investment climate

If a healthy retail investment climate is dependent on:

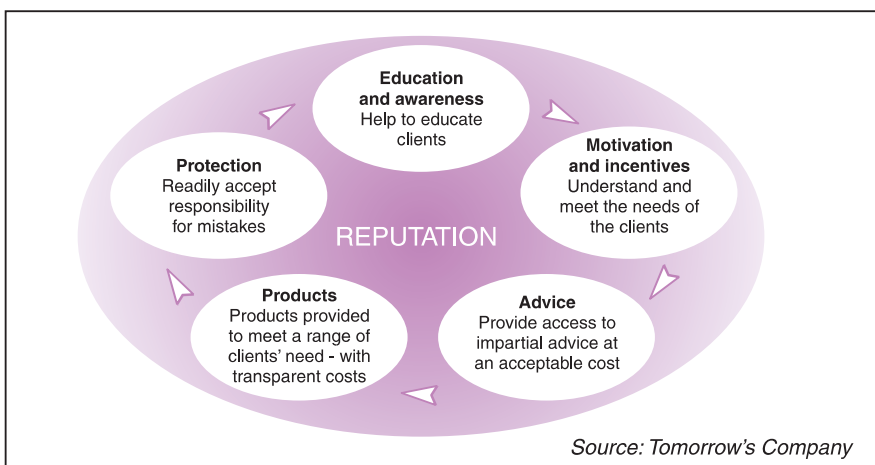
- * investor confidence in the market's products and providers; and
- * an industry with a reputation for fair dealing

the UK financial services industry needs to deliver in a number of areas:

Individual investor perspective



Provider perspective



'...the UK financial services industry needs to deliver in a number of areas:'

Research by DFES has shown that one in four adults cannot calculate the change they should receive out of £2 after buying three items costing less than that. A significant number thought 10% of £300 was worth no more than £25. A more recent survey by NOP for Invesco found that half of investors surveyed (and over two-thirds of the public at large) do not understand the difference between equities and bonds.

The FSA's own research and that of the independent Consumer Panel is also revealing. One quarter of pension and endowment policy holders did not realise that their money was invested in the stock market. Consumers find financial information difficult to understand and frequently fail to read or retain the information provided. Even products designed to be simple confuse consumers – only 33% of consumers thought cash ISAs were straightforward for example.

Carol Sergeant, Managing Director, FSA.⁹

Education and awareness

Research evidence indicates a need for a much higher standard of financial education among the population at large. This extends from understanding basic concepts like compound interest to appreciating more complex issues such as different asset classes and their associated risk levels.

Once armed with some preliminary knowledge people are in a better position to articulate their investment needs.

The importance of financial literacy from an early age throughout adult life is widely recognised:

- * *The FSA has placed a particular emphasis on the need to provide individual investors with the education, information and generic advice needed to make financial decisions with confidence. It has set up a Financial Capability Steering Group, chaired by the FSA's Chief Executive, John Tiner, to develop and implement a national strategy for financial capability.*
- * *The Personal Finance and Education Group has been working within schools across the UK to promote the development of financial capability.¹²*
- * *Citizenship will become a statutory part of the curriculum for all 11-16 year olds in schools in England and contains elements which should help increase financial understanding such as:*
 - *the role of the individual, business and government in the workings of the economy, and how money flows between them*
 - *individual and family expenditure, issues relating to personal finance and saving for the future.*
- * *Our workshop discussions suggested that the workplace is an effective channel through which individuals can receive financial education and information.*

Motivation and incentives

Personal motivation to save for future security is not strong – for a variety of reasons: the young have a natural tendency not to worry about provision for retirement and so postpone thoughts of saving; similarly, for many older people the demands of today's lifestyles, often fuelled by consumer credit, have altered traditional practice of saving for a future purchase to 'buy now pay later'; some see a post-retirement income significantly in excess of a state pension as an unattainable luxury; others regret having made previous investments in which they have or feel they lost out.

Problems arise when providers, in their efforts to motivate people to buy, create unrealistic expectations or use promotional techniques better suited to fast moving consumer goods. Similarly, the arrival of well-known consumer brand names operating in conjunction with financial institutions may well have helped to remove some of the anxiety often associated with buying financial products; but it may also create a false sense of security.

The government and employers have an important role to play in encouraging individuals to save for their future. On the government's part, options range from compulsion to the use of tax incentives. Countries such as Australia and Singapore have taken steps to make saving for retirement compulsory, but against a different social backcloth than exists in the UK. In the Australian example, unintended consequences have been created. Whilst gross contribution to superannuation funds has increased, the more workers are forced to contribute to their pension, the less disposable income they have to spend to oil the wheels of the economy – household net savings have steadily reduced. There also remains the risk that the focus on a lump sum rather than a pension will result in individuals simply spending this on receipt and then still falling back on the state.

Research by the FSA amongst 15 - 19 year olds highlighted that they show little interest in financial matters (as opposed to just spending money) and were very reactive in seeking information about it. Schools were considered by many to be ideally suited as a channel for learning about financial matters but few recall the subject being covered (over 40%* rated their schools coverage of managing money as poor).¹⁰

Achieving a step-change in the level of financial capability is critical to ensuring that consumers are financially aware, can take responsibility for their financial affairs, and are able to influence the market. All agree that there is a great deal to be done but, currently, there are a lot of separate activities and a leadership vacuum. This is where the Steering Group comes in.

John Tiner 11

'The government and employers have an important role to play in encouraging individuals to save for their future.'

Figures from Lipper, the investment data provider, show that a UK investor putting £100 a month into a balanced pension fund - a standard option - over the last 10 years would have accumulated just £11,515, compared with a total outlay of £12,000. The same investment in a UK equity fund would have generated £10,924. Fortunately, contributions into personal pensions attract tax relief at the investor's marginal rate. Basic rate tax has varied between 22 and 25 per cent over the last decade while higher rate tax has been 40 per cent.

A basic rate taxpayer would have received relief of around £2,800 over the last 10 years. Even then, they would have been better off putting the same money on deposit. Over five years, £100 a month dripped into a balanced fund would have accumulated £4,529, while the same amount placed in a UK equity fund would have generated just £4,090 for their investment of £6,000. Even allowing for tax relief, investors would have been better off putting their money under a mattress.

Philip Coggan .¹³

A more acceptable approach therefore is likely to be built through incentivising employers. The ABI has put forward a proposal for a pension contribution tax credit to encourage employers to make the all-important contribution to pension arrangements for their employees.¹⁴

Advice

Saving is not a natural choice for most individuals. It usually takes the intervention of an employer, an adviser or a salesman to prompt the process of deferring consumption to a later date.

This simplifies the process for many savers since the detail of the investment process can then be delegated to a third party - the employer, the defined contribution or personal pension provider (usually an insurance company) etc. The same applies to savers who want more flexibility from their savings (albeit at the expense of certain tax breaks), who opt for endowment policies, investment bonds and the like. In this scenario the detail of stock selection, and even asset allocation, is handed over from the outset to professionals.

People need access to professional guidance on product suitability. However, reliance on such advice can pose difficulties for those who lack the confidence or financial competence to make investment decisions:

- * *Consumers frequently do not value advice sufficiently to pay for its full cost.*
- * *In spite of an emergence of telephone and internet based advice services most individuals seem to prefer face-to-face service.*
- * *Direct sales forces offering face-to-face service are deemed by most providers to be too expensive to operate. Also the sales process itself has been much tainted by accusations of and actual mis-selling.*
- * *Advice now tends to be provided by independent financial advisers. However, if this is paid for in commission it is often perceived as biased.*

The level of charges levied on savers of modest means makes saving unattractive when inflation is low and returns are falling below 7 per cent a year. And the only way to reduce charges of 2^{1/2} per cent or more is to remove the cost of advice. The industry refuses to acknowledge this, because its business model relies on distributing products through financial advisers. The hefty commission paid adds to a bloated cost base which added up to £570 for every household last year, according to Ned Cazalet, the independent analyst. Yet the future surely lies with companies that can reorganise themselves to attract savings from people who cannot afford to pay charges that erode their returns.¹⁶

To measure possible bias, illustrations between outcomes for commission-free and commission paying products would have to pick up all the cost differences, not just the payments going to the agent. Examples of such illustrations, using the FSA prescribed rates for inflation and real investment returns, formed part of a CFSI report on depolarisation.

For example - for a regular contribution of £2,000 a year in today's money for a product such as a modest personal pension, the full likely cost of a typical sales commission for 20 years is about £12,000. On top of that, the product would attract trail commissions of 0.5% a year for an active fund, which amounts to a further £17,000, equivalent together to more than 10 years of contributions. Fee paid advice over the full period would be measured in hundred of pounds, not thousands.

*Stuart Fowler.*¹⁷

The single most important factor governing people's savings behaviour is available, affordable and face-to-face advice (Richard Surface, Oliver, Wyman & Co). There are psychological inhibitors to saving which are deep-seated and which cannot be overcome without face-to-face advice.
Simon Targett.¹⁵

'People need access to professional guidance on product suitability.'

The evidence below appears contradictory but may reflect the fact that people may be more willing to complain against an organisational provider than a financial adviser who they know and trust.

The vast majority of successful complaints against financial advisers relate to those tied to a particular product provider.

Last year, tied advisers were involved in 90% of upheld complaints about mis-sold endowments and 88% of those relating to other investment products, compared to 10% and 12% for independent financial advisers (IFAs), according to the figures from the financial ombudsman service. And the 9,722 complaints upheld against tied advisers in 2002-2003 were up 80% on the 5,394 in the previous year.¹⁸

Charles River Associates (CRA) looked at the effect of commission-based remuneration on financial advice. They found that:

- * *the problem of bias is more serious in the IFA sector than in the tied sector, but it cannot be ignored in the tied area either (though CRA did less work here);*
- * *where there is bias, there tends to be damage to consumers – damage that rebates don't offset; and*
- * *the main damage is really the excessive charges that consumers find they pay.*

CRA concluded that there is no massive problem of commission bias – and not one that permeates all markets. Bias does not seem to be such a problem when it comes to regular premium products; in particular, the personal pension market is very tightly regulated. However, there is some evidence of consumer detriment in some areas - perhaps to a total cost of around £140 million a year.¹⁹

A number of solutions have already been proposed to address the need to restore investors' confidence in the provision of advice:

- * *The FSA rule that requires financial advisers to disclose fully the level of commission received in giving advice.*
- * *The ABI proposal for a workplace advice credit to enable employers to offer financial advice cheaply to their employees. (There are however regulatory issues to be considered and worked through in more detail.)*
- * *The proposal by the Consumers' Association calling for a national network of advisers. The proposed National Financial Advice Network would function as a series of access points and delivery channels where individuals can get customer-focused, quality, face-to-face advice from a new type of financial adviser: the financial para-planner. The access points would be based in locations that individuals are familiar with and would readily visit:

 - *Community-based (Citizen's Advice Bureaux, advice agencies and legal centres)*
 - *Organisation-based (workplace, trade unions, charities)*
 - *In mainstream retail financial institutions that sign up to the Network and employ financial para-planners. Financial para-planners would operate on the lower of a simplified two tier system, gathering and providing information, undertaking basic financial health checks, and in some cases diagnosing the problem and suggesting solutions. More complex or sophisticated cases would be referred to higher level professional advisers.*²⁰*
- * *For those savers not put off by technology there are new channels which can be leveraged to increase accessibility to advice.*

Adviser300 is a radical new advisory service capable of delivering high quality financial planning advice to individuals, employees and members of affinity groups over the Internet, with the added benefit of a telephone link to a fully qualified IFA. It combines best practice financial advice provided by its established network of advisers with proprietary innovations which allow for on-line solutions to be personalised for each individual. The service has the full backing of many of the country's leading product providers and enables its users to benefit from investment and financial planning advice that incorporates time-tested techniques used by many of the world's largest providers. Chief Executive Chris Batten said it has taken two years to get the scheme approved by the Financial Services Authority (FSA), and is the first of its type. Until now, this level of independent investment advice has too often been available only to the world's most sophisticated high net worth/institutional investors and at considerable cost.²¹

'Financial products are sometimes highly complex and too complicated...'

Products are sold and not bought – we have been selling promises.

Quote from consultation workshops

Using figures showing how an investment fund has performed in the past is a popular theme in investment ads. But sometimes even the apparently best-performing funds may not be all they seem, and some companies use these past performance figures to make funds seem better than they really are. One example given by Which is an advertisement that claims that a Progressive Growth Fund has outperformed the FTSE All-Share Index in the 12 months since it was launched. The ad includes a graph which illustrates just how much it has outperformed the All-Share Index. All is not as it seems, though. In fact the figures cover only ten months, not a full year, as suggested by the ad's headline - and the period cited ends on 21 June 2001, two and a half months before the ad appeared. If the graph is extended to cover a slightly longer period the figures are not nearly so attractive. The fund took a sudden and dramatic nose-dive at the end of June 2001. The ad was still appearing in magazines in September, by which time the fund had fallen well below the sector average.²³

Products

Retail products

- * *Financial products are sometimes highly complex and too complicated for the average investor to understand.*
- * *Companies are often and fairly accused of taking the line of least resistance and promoting products that are the easiest and most profitable to sell, rather than ones that might better meet investors' more basic financial needs. Unless the product provider has an established high street presence or a direct sales force, its main source of distribution will be through IFAs. This means that there is distance between the company and its ultimate clients. Also as IFAs increasingly serve high net wealth individuals, the type of product they seek is less likely to be relevant to the 'mainstream'.*
- * *If IFAs take on the role of 'product distributor' rather than agent of their client, there is always the danger that they will become unduly influenced by commission rather than the needs of the investor.*
- * *No one party, working in isolation, can redress the wider problems that emerge from this scenario. Product providers, financial advisers and distributors, need to come together in an industry wide forum which commits itself to product simplification based upon the needs of customers.*
- * *Advertising frequently gives prominence to the potential upside of product performance and focuses on past performance, leaving the risks and costs consigned to the small print. The Financial Services Authority (FSA) is extending its work in this area and setting up a financial promotions team, whose job will include trawling through TV commercials and print advertisements to see whether they adhere to the principle of being 'clear, fair and not misleading'. The FSA has also put in place new rules on the use of past performance in advertising. Standardisation measures forming part of an overall package aimed at cleaning up the way past performance information is used in advertising came into force on 1 June 2004.²²*
- * *There is little emphasis given to alternative investment criteria. For example people may wish to invest in SRI funds, but it remains the case that information about these is relatively difficult to obtain.*
- * *Disclosure of all costs and charges affecting investors' returns remains unclear. The publication of a Total Expense Ratio consistent in its calculation across all funds may be helpful. This may not however, be the most suitable solution for other types of retail product.*

Explaining the costs to retail investors – where does all the money go?

The variety, range and complexity of retail products make it very difficult for investors to make valid comparisons between them. The FSA has done much to oblige investment, insurance and pension product manufacturers to reveal far more to investors; not only of the management charges that they receive, but also the effect of other administrative, operational and fiscal costs and expenses that add to the impact on the subsequent investment return. Figures showing 'what you might get back' over various periods reflect meaningful information for the purposes of comparing such charges; but it is not the whole story.

At the level of the fund, (the core of life, pension and investment ‘wrapped’ products), it is not the annual management fee alone that impacts performance. Certain fund management companies have therefore chosen to include their Total Expense Ratio (TER) in information that they provide to investors. The trade bodies the IMA and AITC both show such figures on their web sites. However, if the investor is to receive helpful information, it is essential for the calculation of these figures to be consistent.²⁴

As explained in an earlier section, transaction charges can be a fund’s biggest cost; but this is not apparent to the investor. The higher the level of turnover within a portfolio, the higher the transaction costs. This may or may not give rise to enhanced performance. Low cost funds do not necessarily provide the best returns – but the same can be said of high cost funds too.

Pensions

The last decade has seen a significant change in the nature of occupational schemes offered to new employees. There has been a shift away from defined benefit schemes for new employees in favour of defined contribution schemes and a significant growth in mixed and hybrid types of pension plan.

‘...a significant change in the nature of occupational schemes’

Drivers of these changes include:

- * *Changing demographics, with a declining birth rate, combined with a significant increase in life expectancy, increasing scheme liabilities.*
- * *Increasing labour market flexibility, coupled with a perception that defined benefit schemes provide poorly for people who change jobs frequently.*
- * *A longer than expected bear market over a three-year period, following a long bull market which had given rise to unsustainable expectations of low pension costs.*
- * *Counter-productive regulatory requirements (in particular the current requirement to include volatile numbers purportedly representing scheme surpluses and deficits in the balance sheets of plan sponsors, rather than merely disclosing them) have contributed to driving employers to abandon defined benefit schemes to reduce volatility in their balance sheets.*

Hybrid Schemes

Hybrid schemes have been developed intended to combine elements of both a defined benefit and a defined contribution scheme. These schemes provide a mix of benefits and evaluate the member’s pension fund on both a defined contribution and defined benefit basis. They vary in design but what they have in common is a re-balancing of risk between employer and employee.

One of the most common hybrids is the ‘nursery scheme’. Defined contribution benefits are provided until a given age, say age 40, at which point final salary benefits can be earned.

A variant is to cap the salary used for calculating the final salary pension, with additional defined contribution benefits being provided for employees earning a higher amount.

Alternatively the final salary formula can be reduced – for instance from 1/60th of final salary to 1/80th – the defined contribution scheme is used to top up the pension to attempt to target the level of benefits intended under the previous final salary formula.

Group personal pensions

In group personal pension arrangements, employees have their own personal pension contracts which are in practice managed by the employer. The employer carries out an administrative function, selects providers and investment funds, and makes payroll deductions, reducing the overhead costs borne by single employees. Approximately 20% of schemes set up since 1995 have included group personal pension arrangements.

Career Average Revalued Earnings (CARE)

A CARE scheme provides a pension at retirement based on earnings each year throughout the period of scheme membership rather than the final salary at the point of, or close to, retirement. This provides a more stable cost to the employer as it removes the volatility of salary escalation especially with members who receive high pay rises close to retirement age.

Each year's earnings figure is effectively increased in line with price inflation (or, in some schemes, National Average Earnings) up to retirement to maintain the pension's purchasing power. The employer does however retain some of the risks of a final salary scheme for example investment returns and annuity prices.

They have been introduced by for example Tesco, Cadbury Schweppes plc, Safeway and Nationwide Building Society.

Defined Cash Fund (sometimes known as a cash balance scheme)

A cash balance scheme may resemble a defined contribution scheme but is, in fact, normally categorised as a defined benefit arrangement. It works in a similar way to a final salary scheme except it is not the pension in payment that is targeted but a cash sum in retirement.

The employer allocates a nominal amount to the member's pension account each year, which is updated annually in accordance with a particular formula. The benefit promise is usually expressed as a fixed capital sum or as a specified multiple of final salary at retirement. This figure is targeted irrespective of investment returns in a similar way to a final salary scheme. The final fund is then used by the member to purchase an annuity (although some of it can be drawn as tax-free cash within the usual limits).

Protection

Within the financial services industry there has tended to be a reliance on the corrective effects of compensation and fines rather than on proactive steps to improve protection. The result is that even when compensation has been forthcoming, confidence has been damaged.

However, protection is something the industry is beginning to assume greater responsibility for; an example of which is the Raising Standards Quality Mark Scheme. This scheme is an example of how the 'statement of principles' can be translated to a specific part of the industry.

The Raising Standards Quality Mark Scheme

This scheme, which was launched in October 2000, is a voluntary scheme open to providers of financial services products.

At its centre is a set of customer focused standards, covering clarity and comparability of information, appropriateness of the product purchased, and quality of service. The standards require companies to provide consumers with:

- * *Clear and comparable information, through standardised key features documents*
- * *A yearly statement, which explains how their policies are performing*
- * *A clear and simple explanation of charges and their impact*
- * *A longer period during which consumers can change their minds after agreeing to buy a product.*

Also, companies must meet or exceed specified levels of customer satisfaction with the service they offer and with the way they handle complaints.

A new independent body, the Pensions Protection and Investment Accreditation Board (PPIAB) has been set up to assess companies who wish to apply for accreditation. The PPIAB awards the Raising Standards Quality Mark to brands that have proved that they meet the standards. It also reassesses the brand each year, monitors their continuing compliance with the standards and will remove Quality Mark accreditation where it finds that standards are no longer being met. To date, nearly two-thirds of the life and pensions market has met, or is working towards accreditation under Raising Standards.²⁵

The mitigation of financial loss through the practice of taking out indemnity insurance cover does provide some protection for investors after the event. All parties from the directors and officers of a company through to their auditors will have some form of cover. However indemnity cover could also have the effect of reducing the rigour that should be applied to the development of products and management of funds by lessening the overall sense of responsibility and accountability to the end investor.

'...even when compensation has been forthcoming, confidence has been damaged.'

It is better to build a fence at the top of a cliff than to station an ambulance at the bottom.

Henri Durant,

Founder of the International Red Cross

Agenda for Change

To resolve the problems associated with the savings and investments of individuals calls for a broad partnership of government, opposition parties, the financial services industry and its regulator, employers, unions and consumer groups.

Flexibility is a major consideration, which will help to encourage individuals to save and make provision for their retirement. This flexibility should encompass, for example, the age at which people retire, the changing needs of individuals throughout their lifetime, and a range of options regarding annuities and taxation arrangements.

Increased education and awareness is vital – individuals need to be able to understand and articulate their needs – ‘what assets do I have?’ – ‘what financial responsibilities do I have?’ – ‘what are my needs?’ – ‘how much risk am I prepared to accept?’ This enhanced understanding needs to be supported by products which are described in a simple and unambiguous way. Charges and expenses need to be transparent; risks apparent – also trusted advice needs to be available at an affordable price.

Our proposals

In the area of education and awareness – we propose:

This is a long-term issue and cannot be addressed overnight. It requires a commitment to implement changes that will need to be constantly revised and refreshed over a number of years. This is also a cross-generation problem and one that needs to be addressed for both those currently at school so that they are better equipped to manage money in the future and for those in later life. Notwithstanding these issues, we propose the following:

** The teaching of basic finance should be compulsory in the school curriculum. This should develop an understanding of budgeting, simple financial management and key principles such as compound interest; also how the marketplace operates.*

** The success of projects such as Young Enterprise needs building upon. This has been successful in getting school pupils to run their own businesses. It might be possible to add a dimension to that strengthens understanding of saving and investment.*

- * *More complex financial concepts and how to plan for retirement should be addressed in higher and adult education so that individuals are able to articulate their needs and make informed judgements.*
- * *Suppliers of financial products should take action to enable individual investors to develop a better understanding of risk. For example through introducing standardised risk reporting and through guidelines on how risk should be reported in investors' portfolios.*

In the area of motivation and incentives – we propose:

- * *The major political parties should clearly set out their long-term approach to means testing and the treatment of savers, so that individuals are in a better position to make decisions based on a reasonable expectation of stability of government policy. Ideally this would become a matter of political consensus, allowing individuals to make long-term decisions with more confidence.*
- * *Fiscal incentives for savings and pensions should be considered so as to reduce dependency on state pensions – and encourage long-term saving. For example: taxing all gains within the early years as income, applying a reduced rate for a period thereafter and then charging no tax – i.e. short-term gains treated as income and ending with long-term gains being tax free.*
- * *Companies to be incentivised to contribute to stakeholder plans as a means of reversing the disappointing take-up by individuals.*

In the area of advice – we propose:

- * *In the light of the depolarisation debate – the principles of stronger relationships, deeper dialogue and transparency and alignment of incentives need to be applied by all those involved.*
- * *Financial advisers place an increased emphasis and focus on meeting the needs of the individual beyond the minimum requirements set out for compliance.*

In the area of products – we propose:

- * *Building on the FSA's advertising guidelines, the industry should agree a set of guidelines which specify precisely the occasions to use descriptions such as 'bond' or 'guarantee' in retail products.*
- * *The industry should be encouraged to develop a classification matrix which would more clearly describe the type of product and the level of risk, not only in absolute terms but also relative to the nature of the types of liability that the customer would be trying to meet.*
- * *Within the constraints of the existing total taxation benefits derived by pensions savings, a system should be devised that gave greater flexibility to savers and pensioners, to enable them to save and to take the benefits of the pension savings, at a time which suited their individual requirements. This would, for example, give greater flexibility in taking annuities at the time of retirement.*
- * *The industry should build on the current regulatory requirements and disclose in regular statements to investors the costs incurred in managing the product.*

In the area of protection – we propose:

The 'statement of principles' proposed earlier, combined with the forum, is one way in which the industry can show its willingness to become proactive in protecting the individual investor.

Consumers have no concept of risk – they'll take the risk provided they don't lose any money. Education is a long battle, but you've got to start somewhere. If you look at the distribution chains, good quality advice is required, but in reality advice is variable and there is a need to raise standards.

Quote from consultation workshops

The mind-numbing complexity of the Pension Credit is already a factor in the savings decisions of the many rather than the few. This has to stop. The state framework should support the few, but send an unambiguous, urgent message to all that it pays to save.

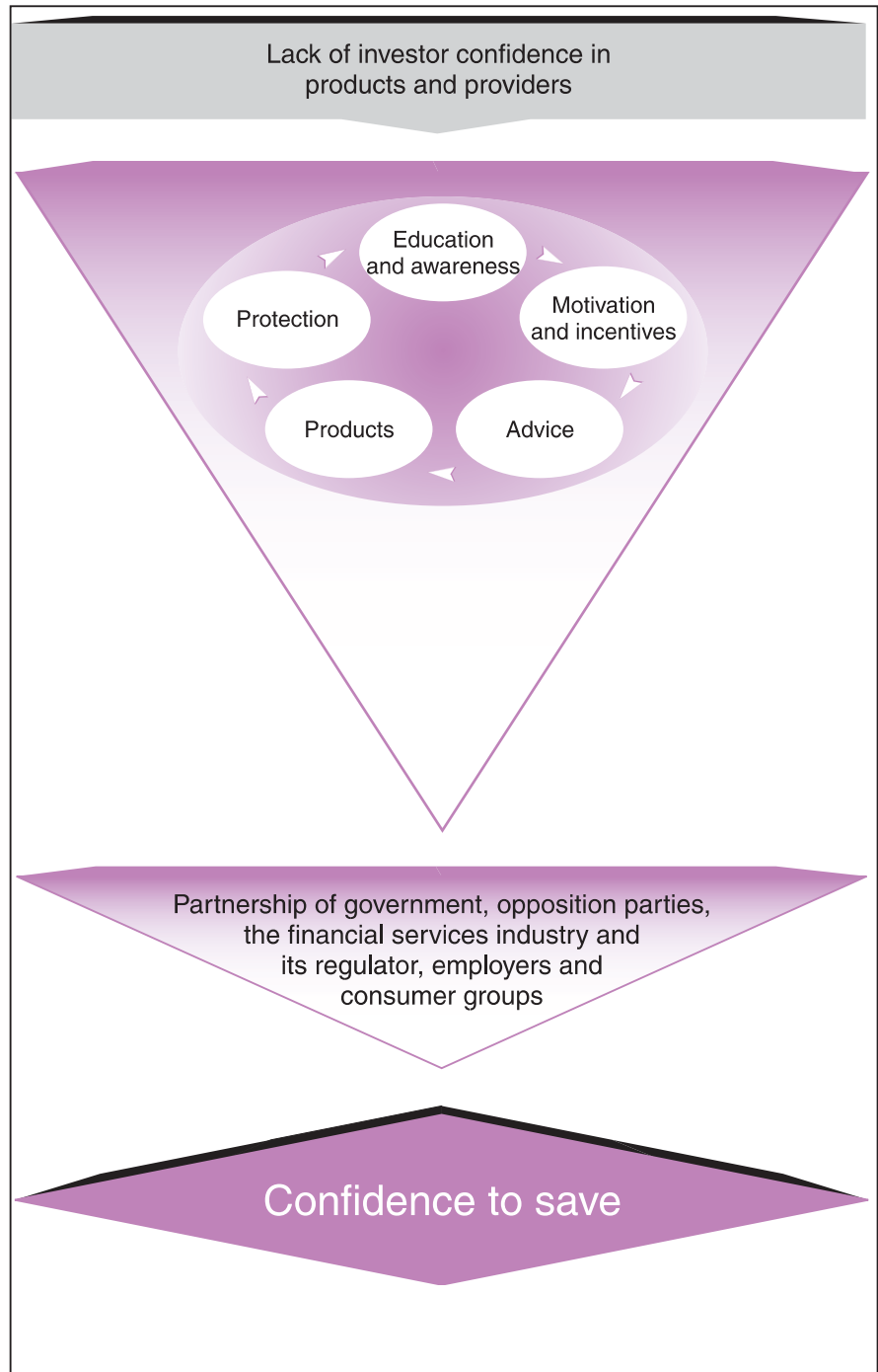
*Francis McGee,
Head of Regulation and Strategy, Association of British Insurers.²⁶*

It is hard to relate the decision you make to the life you want to lead. Compare buying a product from the finance industry with buying a car. You know where you are going with the car. You don't need to look under the bonnet to control what is going on there. It should be possible with finance to define the returns you want when you want them.

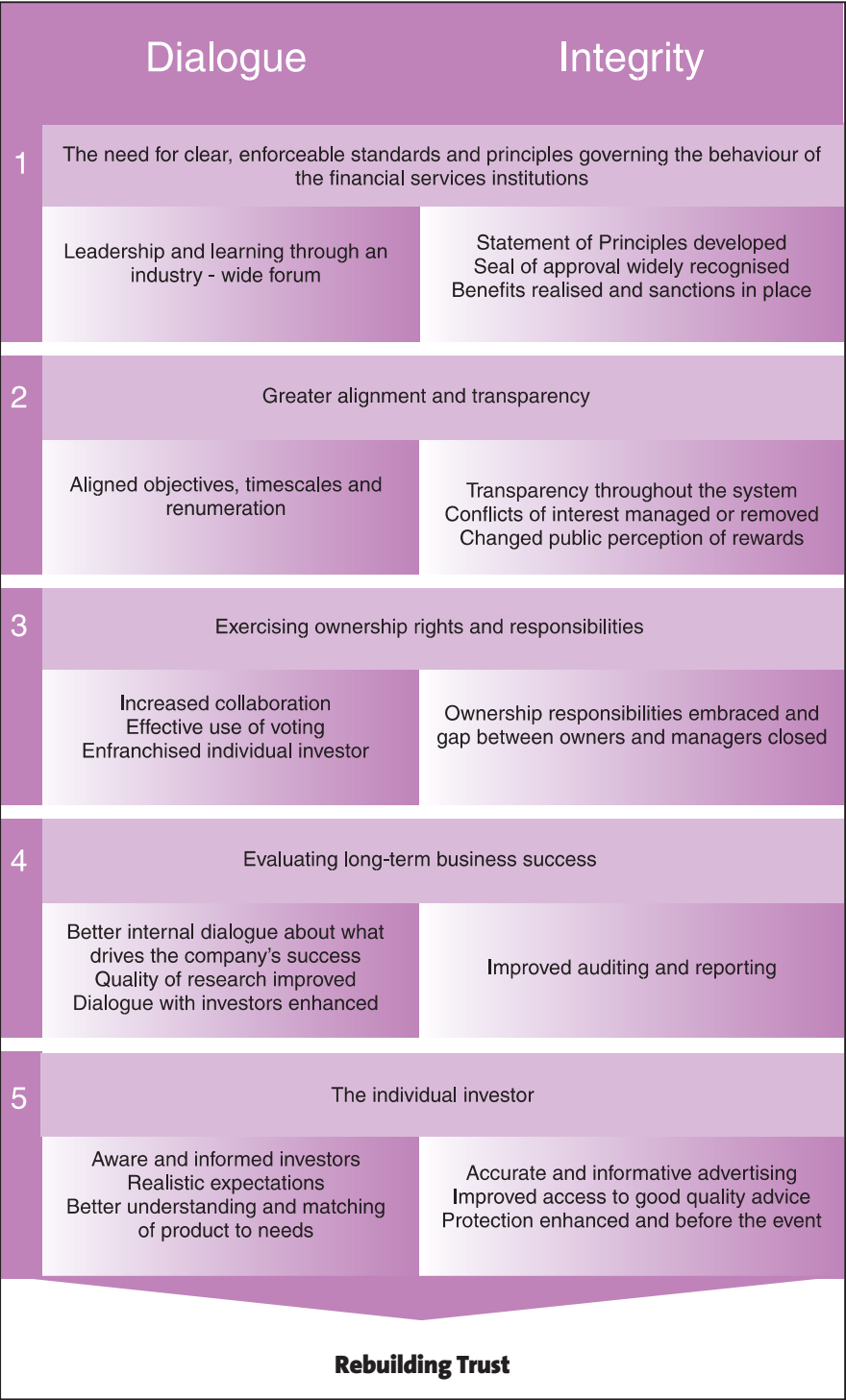
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Trust and integrity – the individual investor

Putting it all together



The Overview



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- * *closing the gap between business and society.*