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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 Indeed, the details described in this report may soon be out of date, but the principles will endure.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.

Richard B Sykes

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.

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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.

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Mark Goyder

Mark Goyder
Director
Tomorrow's Company
June 2004

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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 onthe 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.

Restoring Trust: Investment in the twenty-first century is the result of consultation and research by Tomorrow's Company under the guidance of an Inquiry Team chaired by Sir Richard Sykes. The inquiry has drawn on interviews and workshops with over 500 people from every link of the investment chain.

Unique in its 'helicopter view' of the investment system as a whole, *Restoring Trust* looks to a long-term agenda for improving investor confidence and warns that the industry now faces a stark choice – to live by its own standards or face ever-increasing regulation.

Tomorrow's Company is a not-for-profit research and agenda-setting organisation committed to creating a future for business which makes equal sense to staff, shareholders and society.

Its business-led programme of publications, events and activities focuses on three issues fundamental to the future success of business:

* *an improved investment system;*
* *an inclusive approach to leadership and governance;*
* *closing the gap between business and society.*

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