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



Restoring trust
Investment in the twenty-first century

Speech by Sir Richard Sykes

15 June 2004

An inquiry into the effectiveness of the UK investment system

Good morning.

Thank you Clara, for your welcome.

Thank you to the London Stock Exchange, represented on the Inquiry Team by Martin Graham.

It is all too rare to see such experienced and able people give so much time and energy to a wider agenda.

This is one of the factors that makes this Inquiry unique.

Our Methods

This is an industry self-portrait.

The messages from this report come straight from the front line.

Based on 17 workshops; a public call for evidence; interviews, private consultations, and of course the investment summit. Over 500 people from companies and all parts of the investment system.

Tomorrow's Company set us a very challenging task. But the whole team lasted the course and on behalf of Tomorrow's Company I would like to thank them for their commitment.

Each and every member of the team has said, in writing, that this report is not just a call for action by others, but a commitment by **them** to do all they can to realise the vision we have described.

There have been lots of reviews of **parts** of the system – from Myners to Pickering, from Sandler to Penrose, from Cadbury to Higgs.

We've had the wrist x-rays and the chest x rays. This is the only total body scan.

We've got something valuable in the UK. For all our faults, we have a tradition of business and the professions being trusted to put their own house in order.

In the investment and financial services industry, we have a lot to be proud of. Other people admire our regulation, and the high standards of integrity.

But, in our view this industry, for all its merits, has suffered a near fatal erosion of trust.

There are a lot of people who recognise the problems, and are working very hard to put them right. But separate initiatives are not enough – there needs to be a collective focus and collaborative approach if the confidence is to be restored.

Our Findings

‘Restoring Trust’ is the title which we chose for this report.

Trust is the ticket to freedom.

Lose the trust and you not only drive away your customers, you have no defence against politicians and regulators, and the lawyers!

Don’t think that you can take this Report and read it on the beach. It is 120 pages long. It contains 52 recommendations.

All I can do now is to give you a flavour of it and then, helped by my colleagues, answer some of the questions you have.

Three key themes

From the whole report I would like to single out three key themes.

- * *The first is about the culture change that will be needed, if this industry is really to start putting the customer first.*
- * *The second is about the need for change, on one hand, in the way companies deal with their investors and, on the other hand, that investors deal with companies.*
- * *The third is about the leadership that will be needed and where to start*

Theme 1 – A culture that puts the customer first

Trust in the integrity of the financial services industry has been eroding just at a time when we need to save more.

The contribution of governments

A common complaint is that successive governments seem to move the goalposts. In the report we recommend that

- * *All political parties clearly set out their long term approach to means testing and the treatment of savers. Ideally this should become a matter of political consensus.*
- * *Companies be incentivised to contribute to stakeholder plans.*

The responsibility of savers

Only one-in-eight savers surveyed earlier this year said they would be willing to take the risk of investing in shares. Mind you, a quarter of pension and endowment policyholders were surprised to hear they already invest did invest in shares!

People's understanding of investment risk is woefully poor.

Long term, we need to change this. You will find a large part whole of the report devoted to

- * *Improving investor education*
- * *Making the teaching of basic finance compulsory in the school curriculum*
- * *Introducing a clearer risk language for consumers*
- * *Increasing transparency about charges.*

That said, the onus for change lies with the investment and savings industry, not the consumer.

The responsibility of the industry

And the trouble is, we don't see the scandals suddenly stopping. We think they are an inevitable outcome of the way financial services is working.

There have been so many examples of mis-selling; the promotion of unrealistic expectations; and misleading advertising.

We quote an example in the report about a fund management company advertising their growth fund's performance over 12 months but only actually using the figures for 10 – excluding two months of underperformance which takes the performance way below the sector average.

Too often it's all about making sales and getting commission, and not about truly seeking to get close to customers and design products to meet their long term needs.

There is also the lack of transparency on charges. People need to know where all their money is going.

A bear market doesn't help either! A UK investor who put £100 a month into a balanced pension fund over 10 years to February 2003 would have saved £12,000 and have units worth just £11,515. Even with tax relief they would have been better off putting the same money on deposit.

According to one study quoted in the report, for a consumer contributing £2000 a year into a modest personal pension, the lifetime cost of salesman's commission is about £12,000. If the money is going into active fund management, there is further commission to pay, and one expert has worked out that the total together adds up to more than ten years of contributions!

It's too late to blame anyone for this. We just have to change it. That means a change of culture

- * *For salesmen.*
- * *For fund managers*
- * *For advisers*
- * *And for providers.*

The industry should stop misleading advertising - not wait for the regulator.

We must not give high salaries and bonuses to those who land the biggest sales, but those who really put the customer first.

But we are not just talking about the retail end. We are equally concerned about the lack of alignment of the incentives and remuneration of the whole industry.

We quote evidence about the leadership vacuum and lack of direction in many fund management companies, about a culture characterised by star performers, inflated egos, a lack of loyalty to both client and employer, conflicts of interest and a blame culture.

To reinforce the culture change we are suggesting:

- * *Pension fund trustees should be helped by investment consultants to set out their expectations more clearly.*
- * *Fund managers should have a full understanding of the rationale of the pension scheme and the liabilities they are meeting.*
- * *Fees paid to fund managers should be more closely linked to the performance criteria agreed with the trustees.*
- * *All companies, everywhere in the system should clearly state the principles on which they reward people.*
- * *As part of the move to link pay more closely to long term performance, there should be a greater weighting in favour of shares and against options.*
- * *All charges should be revealed, even those which may currently be “hidden”.*
- * *100% disclosure of conflicts of interest.*

Theme 2 - Ownership and longer term performance

This brings me to the next big theme in the report. A large part of “Restoring Trust” is a description of the many steps that need to be taken by companies – by trustees, by investment consultants and by fund managers together so that we can get the chain of corporate accountability working properly.

The key issue was summed up for us by a CEO at one of our workshops.

“Years ago owners acted as real shareholders, they were closely involved, knew the company and would cause grief. 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.”

Once we have a system that puts the customer first as matter of habit, we can begin to imagine some equally vital changes seeping through the way investors interact with companies to close that gap and grow that understanding.

People need to be confident that their money is invested in healthy businesses with long-term prospects.

There is a place for share trading. But equally there is a vital place for old fashioned ownership, for buying and holding and using that ownership stake to improve the performance of a company.

As one fund manager puts it in our report:

“I think the fund management community must understand its responsibility and not just its power...we must make sure that the capital of our savers, the ordinary men and women Britain who contribute to their pension funds, that that capital is properly applied.”

Many of the fiduciaries representing companies' largest shareholders, have effectively abdicated their responsibility as owners.

This can be changed. In particular we suggest:

- * *The largest shareholders in a company - say the top five or ten – should pool their resources and start working together. This is much more productive and less wasteful than having every investor build up its isolated governance resource.*
- * *We need to develop really effective league tables, so that trustees (or retail investors) select investment managers partly at least on their ability to be responsible owners.*

Imagine the personal finance pages of the newspapers advertising for ISA's not only trumpeting the fund manager's performance but their ranking in the responsible ownership league tables. We think it is up to the investment consultants to take the initiative in creating these league tables.

At the same time:

- * *Pension trustees could focus on mandates for the longer term – say 7 to 10 years*
- * *This could boost demand for really credible research into the long term potential of companies*

We are not just hammering the investment community. There needs to be corresponding change on the part of companies.

- * *Companies should be more forthcoming in explaining their strategy, reporting on this in the new Operating and Financial Review.*
- * *We want them, like everyone else in the system, to ensure that pay truly reflects sustained business performance.*
- * *And that acquisitions serve the long-term objectives of their shareholders.*

As another participant at our consultation workshop put it

“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.”

The inquiry heard of examples where companies read about investor unhappiness in the newspapers, but had had no direct communication of such unrest. Somehow institutions need to find a sensible place for the kind of supportive dialogue between owners and managers that helps the company address its underlying problems.

Equally, there is something wrong with our system if expensive takeovers become the only way in which an underperforming management is dealt with.

We quote the evidence in the report that the vast majority of takeovers destroy value for investors, although a number of advisers and others may do very nicely out of them. And we recommend that as part of their Operating and Financial Review companies regularly review how successful they were in takeover activity. We suggest investment banks might find it salutary to review how few of the schemes they come up with turn out to be value enhancing.

Theme 3 – Leadership

Which brings me to the third theme. Leadership.

Right across the system, we recognise that there are efforts being made to improve things. One by one, conflicts of interests which we describe are being tackled – a recent example being the agreement between the FSA and the fund management industry for greater disclosure in the light of CP 176 on the unbundling of research costs.

Equally the industry has made efforts at various times to improve the quality of product information.

I do not want to knock any of these efforts. But they are not enough, and they have not stemmed the erosion of trust.

Look at the comments only a few days ago from Ann Foster, Chairman of the FSA's independent Financial Services Consumer Panel, who said

“Far too much of the industry is still characterised by mis-selling, misleading advertising and a failure to treat customers fairly. We implore the industry to take steps to bring everybody up to the standards of the best. We should share a goal of restoring confidence in this important market.”

We need a change of attitude, not just rules. We need a decisive shift away from the industry's opaque past.

There has to be the mailed fist of the regulator's power, but we also need the velvet glove of a well-led industry to shape the necessary change.

Without this regulation can become a nightmare. Let me give you an example.

The inquiry learned that, a few years ago, a number of key life companies came together to set a maximum commission. They recognised that the commission culture was part of the problem. The Office of Fair Trading said their initiative was anti-competitive!

They may have been right in theory, but they had failed to understand the systemic implications of their decision.

In financial services, the effect of increasing commission is to

- * *skew the decisions of the distributor*
- * *increase their conflicts of interest*
- * *lessen the effective choice that you are offering*
- * *increase the price to the customer*
- * *weaken the service to the customer*
- * *and to undermine that customer's trust.*

We have to find a process in which the industry begins to show a clear and united view on the changes it needs to make, so that regulation can build on those strong foundations.

At the highest level, we start with a 'Statement of Principles' governing the industry.

Investment and savings is a fiduciary business. It is very like medicine, where you entrust a professional to make a decision. By the time you can tell whether the doctor was right, it may be too late. So the medical profession has for centuries, had a simple code that guides their behavior.

In savings and investment you are entrusting a much less well co-ordinated series of professionals with decision-making over far-reaching aspects of your wealth.

Consumers should, of course, check out the options for themselves but you cannot expect people to understand it all. They have got to be able to trust the financial services professional to put their interests first.

Would a Hippocratic Oath work for us?

So what about a Hippocratic Oath? I can hear people saying ah, the financial services industry is far too fragmented.

But it is exactly for that reason that we are proposing that they come together and create a forum for self-regulation, whose first agenda item would be the creation of high level principles. This would give a flexible but shared criterion by which all the industry associations and professions could judge their own actions.

If problems were spotted, the question would be simple: is it consistent with the high level principles? If there were any doubt about it, then the company proposing a risk new product (or operating a questionable commission scheme, or failing to disclose product charges, or failing to declare a conflict of interest) would have to defend their actions in front of the forum – long before the product or practice could become the source of the next major scandal.

“How do we compete in that environment?” would be the cry. Well it all depends what you want from competition. You may get a smaller slice of the cake but in return the cake itself will be that much larger.

Over time, this effective self-regulation by the industry would have the potential to encourage the FSA to adopt a lighter touch in regulation.

Other Industries

Again, to those people who say this is naïve and impossible, I would invite you to look at examples in other industries.

- * *The alcoholic drinks industry, faces rising public concern, but at least it can draw on the successful example a few years back when the consumer and the industry was saved from Alcopops, thanks to the intervention of an industry led body called the Portman Group*
- * *The National House Building Council, which has for decades been an industry-led standard-setting, body which took the initiative to protect its reputation and its customers against poor quality building*
- * *The Association of British Travel Agents, whose travel bond gives customers some comfort against the risk of default of one of its members.*

In the United States

And in the States there is now the Insurance Marketplace Standards Association.

This initiative came in the aftermath of mis-selling scandals in the USA. Sales practices had cost the customer billions, and damaged the insurance industry. A number of companies took the lead, drawing up a stringent set of standards for ethical business conduct.

In 1996 the Insurance Marketplace Standards Association (IMSA) was formed with a mission to strengthen trust and confidence in the life insurance industry.

IMSA is an independent non-profit membership organisation. Its members now represent nearly 60% of the overall market share for the individually sold life insurance and annuity business in the USA. Member companies must police their own adherence to its code, which starts with six high level principles starting with honesty, fairness and treating customers as you would wish to be treated yourself.

IMSA is now able to claim that it has created a process that pre-empts problems before they become matters of widespread complaint or litigation.

So by all means criticize our proposal for a statement of principles and a forum, but don't try to tell me that you are happy with the status quo: come up with a better answer to the problem!

So the people in this industry can, if they choose to:

- * *come together*
- * *set out what they stand for*
- * *cut out the waste, unnecessary complexity, and the conflicts of interest*
- * *align incentives and ownership behaviors with the longer term needs of customers*
- * *educate customers better about risk and reward*
- * *and so make their activities more understandable and more trustworthy.*

Change

I have no doubt that this business will change. The only question is how. In this report we offer a thoughtful agenda for self-disciplined evolution, in which the industry retains the initiative. The alternative it seems to us, is lost customer opportunities and even more red tape. The choice is between leadership and suffocation.

The people who are most at risk will be the generations of savers and investors who are voting with their feet and choosing to make little or no provision for their old age. We owe it to them to sort it out. That's why we called our Report 'Restoring Trust'.