Tomorrow's Finance

Tomorrow's Company in partnership with MAM Funds plc

MAM

tomorrow's company

Foreword

The world is at a major turning point. A global credit boom that has lasted for over two decades can no longer be taken for granted. Changing times are often a challenge, and this one looks more challenging than most. Many governments – especially in the West – are faced with austerity, and high unemployment.

There are other changes that are for the better. There have been obvious excesses. Many feel it has become too disconnected from the underlying economy. The status quo cannot continue. Fundamentals need revisiting.

At times of flux, there is a greater need for informed debate. What is the real purpose of our financial sector? How can we build a finance system that is fit for purpose? Tomorrow's Finance has been established as a forum for debate. To bring together major industry figures holding diverse opinions with those asking urgent questions.

All of us at MAM are enthusiastic in working together with Tomorrow's Company to find numerous ways to facilitate this interaction. Roundtable events, panel discussions, lectures… good ideas need to be heard and discussed. This booklet is an invitation for you to consider these issues and share your opinions. It sets out an agenda for debate – not the final word. Differing points of view will be a source of strength.

Tomorrow's Company welcomes Gervais' leadership through *Slow Finance*. Tomorrow's Finance will be strengthened by the support of initiatives such as Long Finance, and reinforces our agenda setting work on governance and stewardship, on capital markets and value, and our collaboration with the City Values Forum.

Tony Manwaring

Gervais Williams
Managing director
MAM Funds plc

Tony Manwaring
Chief executive
Tomorrow's Company

Introduction

> *"Finance is, as it were, the stomach of the country, from which all the other organs take their tone."* W.E. Gladstone

The financial services industry consists of a range of individuals, professions and institutions deploying a range of financial and related skills. Some parts are highly regulated and transparent, others less so. It is a global industry, but at its centre stands the City of London. It plays an important role in the UK economy in terms of employment, incomes and invisible exports.

Some of its institutions have been collectively and individually held responsible for the series of financial crises which began in 2007, the repercussions of which are having severe consequences for other parts of the economy and are still a shadow over world economic activity five years later. This has resulted in a serious loss of trust in these institutions and in the whole system and has led to calls for greater regulation and changes in the structure and behaviours of the industry.

As well as repairing past damage, however, it is important to look into the future and visualise what a sustainable financial services industry might look like in 2020. Here the starting point must be the industry's ability to adapt to the changing needs of business and society and this cannot be achieved if the financial system, or a significant part of the system, operates in a parallel world remote from the 'real economy' and the challenges posed by economic imbalances, ageing populations and the degradation of the natural environment.

What is the financial services industry for?

The basic question is ‘What is the financial services industry for?’ – What purpose or purposes does it serve? And who are the customers for whom services are provided?

At one level the answer is simple – it exists to provide services to people and institutions who need some form of intermediation in their financial transactions – borrowing, investing, saving, leasing, insuring etc.

At a deeper level, however, lies the question: ‘What is the function of the industry in relation to society given its pivotal role in the whole system and to what extent can it be a force for good?’

Within this overarching question, people are also asking:

- What is the balance between serving the interests of its clients and serving its own interests?
- Why are the rewards of the key players so much greater than those of people in similar positions in the ‘real economy’?
- How did speculative activity and the trading of risk grow to the extent that it greatly exceeded the value and volume of the basic activities of capital raising and asset management?
- How did a sales driven culture lead to the mis-selling of billions worth of flawed investment plans and insurance policies?

The value of financial services to the UK

Using UK tax payments by financial services companies in their accounts year ended in the tax year to 31 March 2011, it is estimated that the financial services sector as a whole had taxes borne of £27.6 billion (bn) and also collected total taxes of £35.4bn. Adding together these figures gives a total tax contribution of £63.0bn from the sector, which is 12.1 per cent of total government receipts from all taxes.

The sector employs more than 1.1 million (m) employees, which is a significant part (3.9 per cent) of the total UK workforce.[1]

Knock on effect of the crisis in the financial markets on the UK 'real economy'

- unemployment has risen from 1.7m in 2006 to 2.7m in 2012
- mortgage arrears rose from 1.08 per cent in 2007 to 2.55 per cent in 2011
- there were 27,100 homes repossessed in 2007 and 36,200 in 2011
- the number of companies going into liquidation rose from 12,507 in 2007 to 19,077 in 2009 and was 16,045 in 2011
- negative growth – UK GDP peaked at 2.8 trillion in 2007 and was just under 2.5 trillion in 2010.

[1] *The Total Tax Contribution of UK Financial Services*, fourth edition report prepared for the City of London Corporation by PwC, December 2011 (London).

The City since the 'Big Bang'

The dominant economic ideology of the last 25 years is embodied in the so-called 'Washington Consensus'. It is an ideology that traces its roots to longstanding policies of the International Monetary Fund and to the adoption by the World Bank of ideas in vogue in Washington early in the Reagan administration concerning deregulation and supply-side economics, the policies of the Thatcher government in the UK and neo-liberal tendencies of the business community and the economics profession in the US.

Among the favoured policy prescriptions of the 'Consensus' is financial liberalisation at the global level. Domestically it is achieved by weakening or removing controls on interest and credit and by diluting or removing the differences between banks, insurance and finance companies. Internationally financial liberation involves removal of controls and regulations on both the inflows and outflows of financial instruments that move through the financial markets. It is the implementation of these ideas and policies that is perhaps the single most important cause of the considerable innovation in financial products and the related surge in global financial flows. All financial institutions expanded but perhaps it was the banks that expanded the most with the issuance of so much additional credit. Increasingly cheap credit over a period of 20 plus years has facilitated trading profits in ever increasing magnitude. An increasingly wide range of assets have been perceived as offering potential for capital gain.

Within the industry itself, this surge in both the volume and nature of financial products has been influenced by technological advances that have facilitated the growth of virtual markets, 24-hour electronic trading and the deployment of highly sophisticated quantitative models to identify arbitrage opportunities.

Innovation, complexity and speculation

Since the late 1980s a major consequence of these ideas has been the growth of the ‘casino economy’ of the global capital and foreign exchange markets, a virtual market place in which actors, both corporate and individual, engage in speculative activity which affects share prices and commodity prices.

According to the Bank for International Settlements as of April 2010, average daily turnover in global foreign exchange markets is estimated at US$3.98 trillion, the greater part of it speculative in nature. While a small portion of the activity of the global capital and money markets is directly associated with the ‘real economy’ of production and trade, the vast majority is composed of portfolio transactions seeking to make a trading profit.

> *“Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.”* John Maynard Keynes

Professor Susan Strange (1997) was one of the first to compare the speculative activity in the financial markets to a ‘casino’. She observed that the big difference between ordinary kinds of gambling and speculation in financial markets is that one can choose not to gamble at roulette or poker, whereas everyone is affected by the ‘casino economy’. What goes on in the trading rooms of banks and hedge funds is apt to have sudden, unpredictable and unavoidable consequences for individual lives.

The growth of speculative activity has been accompanied by the invention of ever more complex derivatives to enhance return through greater gearing, sophistication and volatility. The market for these products has been growing rapidly, both on futures and options exchanges.

Industry concentration

Deregulation has also resulted in considerable concentration of the industry as former banks, insurance companies or merchant banks acquired brokers, asset managers and other types of institution, leading to the absorption of such traditional City firms such as Robert Fleming & Co., Phillips & Drew, Morgan Grenfell and Kidder Peabody.

This change has not just occurred domestically, but was driven by global players operating across the world's major capital markets. A key dynamic and issue arising from this consolidation process is the very large size of the major banks and the fact that they are seen as 'too big to fail'. This has led bank executives to believe they will always be bailed out, even if they take huge risks. The insurance industry calls this a moral hazard.

Behavioural change

The 'Big Bang' and the associated changes referred to above has also been central to a significant shift in professional behaviour within the financial sector. Put simply, both tone and mindset have been to a large degree set by those who have found new ways of making ever greater profits while relying on greater complexity and sophisticated financial models. These individuals have been seen as the 'rain makers', people who have been put on the 'corporate pedestal' and as experience has shown were often considered untouchable within the organisations employing them.

This change, some would argue, occurred at the expense of those who saw financial services as a business built on sustainable longer-term relationships and the ability to deliver normalised returns over the long term. The old 'gentlemanly' practices and values of the traditional family firms gave way to a macho culture with greater emphasis on participating in big deals.

This in turn had a knock on effect on the escalation in rewards, and particularly the bonuses of the senior traders and directors of financial services companies.

All these factors have impacted the dynamic of financial institutions and in the case of the equity market have contributed to some significant changes in the structure and dynamic of the fund management industry. As market volumes increased it became easier to make a series of capital gains through transactions. These gains could be enhanced by the use of debt. These methods offered the prospect of greater profit than more conservative methods such as the compounding of dividend income over the long term.

There has also been a change in the perception of quoted companies. For many they have become vehicles offering the possibility of transactional gain rather than commercial businesses with the scope to grow dividends in the long term. Indeed, during the credit boom the management teams of quoted companies were increasingly incentivised to use extra debt in their corporate financial structure. The financialisation of assets contributed to major changes in the structure and dynamics of investment portfolios, including:

- in the UK the average duration of equity holdings has fallen from around five years in the mid-1960s to around two years in the 1980s. At the turn of the century, it had reached just over a year. By 2007, it had fallen to around seven and half months
- a sharp increase in the percentage of shares in UK companies held by overseas investors – from 30.7 per cent in 1998 to 41.2 per cent in 2010
- a corresponding decline in the holdings of UK pension funds, from 21.7 per cent to 5.1 per cent over the same period.

Furthermore, the 1990s was a decade of continually rising share prices and related investor confidence – the longest running bull market since World War II. It was also a period which saw a large number of financial collapses, scandals and cases of fraud. But as each new debacle outdid its predecessors in scale and complexity, the strength of the bull run and the confidence of investors remained unshaken. The general view was that the financial markets were not spinning out of control; bad apples would inevitably appear from time to time and would be dealt with, but the overall financial system was not seriously threatened.

The near collapse of the system in 2007/2008 shattered the illusion:

- it turned out that many major banks and insurance companies were in fact highly vulnerable to the risk of systemic and catastrophic failure
- governments were obliged to bail out their national banks irrespective of the potential cost since their reserves were over-optimised at too low a level.

Since that time the authorities have mandated banks to increase their reserves.

To try to reinvigorate economic growth central banks around the world have adopted a new policy known as Quantitative Easing (QE) which involves buying-in government bonds. Injecting extra money into the financial system in this way has brought the major economies back to some form of stability, albeit with lower levels of tax revenue and higher levels of unemployment. But in doing so QE has also driven asset prices back up. Share prices in many countries are once again reached levels similar to the 2008 peak. The economic effect of QE for market participants is not dissimilar to that prior to the credit boom.

Yet despite the major financial problems apparent in 2008, many attitudes and behaviours in the financial sector have still not greatly changed.

Reporting on the credit crunch has focused on two things – the huge losses sustained by the financial institutions implicated in the crisis and the huge sums devoted by governments to bailing out the banks. Yet there have been other consequences in terms, for example, of the social and political impact of unemployment, particularly youth unemployment.

Looking to the future

The future of the financial services industry is not just a matter of restructuring or new regulations which clever people can circumvent. In the current debate there is a misguided focus on getting back to ‘business as usual’. That is a recipe for disaster. The biggest mistake we can make is to design the future financial system on the trends, change and needs of the past. The challenge is to re-think the role of the industry in the context of fundamental changes that are going on across the world.

Tomorrow’s Company, in association with MAM Funds plc and others, is taking up this challenge through a series of debates, the first of which in March 2012 was led by Gervais Williams and based on his thought provoking book *Slow Finance* which highlighted resilient methods of investing which avoid those risks evident in 2008, but also methods that also have a history of delivering higher returns than transactional-led strategies.

The fundamental assumption underlying the debate is that the needed changes cannot be achieved without reassessing the central role the financial industry plays in our economic and social system and in turn ensuring the right values and culture are established to enable it to deliver on its mission. For many this will demand a radical culture change in the financial world, a change which restores trust in the system or its institutions will wither and be replaced by others which are seen as truly serving both the public interest and the needs of borrowers.

In those parts of the world where the market economy, in which global finance plays a pivotal role, has driven economic growth, living standards of millions of people have been lifted. But the world is now undergoing a period of unprecedented change. In some respects it is nearing a tipping point and it is becoming clear that the current institutions and practices which the market facilitates are leading to unsustainable outcomes.

There are major issues facing the world, many of which the market has not resolved, particularly climate change, areas of persistent poverty, the loss of biodiversity and the natural world. We are also facing the challenges of meeting the needs of a society with a growing and ageing population, providing energy, food and water.

The solutions to all these problems lie partly in the maintenance of economic growth, else otherwise where will the necessary resources come from? But the solutions will need radical and innovative solutions, with investment over the long term and returns which cannot be measured in monetary values alone. Is the financial system going to be part of the solution to this agenda or part of the problem? If it wants to maintain its pivotal role it will need to transform its structure, processes and culture. But can it play this role if it is seen to be distanced from society and its customers and motivated by the short term and a desire to take a disproportionate share of the rewards?

Encouragingly, many of today's most progressive organisations across sectors understand that the purpose of business is to create value for all their stakeholders – customers, employees, investors, suppliers and society and that the interests of all these groups are inextricably linked. Therefore, sustainable value cannot be created for one group unless it is created for all of them. They also understand that they operate within the triple context of interrelated economic, social and environmental systems and that value creation for the organisation's immediate stakeholders cannot be achieved in a sustainable way if, in the process of its creation, the impact on the wider economy, on society and the natural environment is damaging.

On a positive note, there are many initiatives currently ongoing which are creating a pressure for system change and which are addressing the key issues of values, incentives and culture. One such example is the City Values Forum, building on the work of the Lord Mayor's Initiative on Restoring Trust in the City (in which Tomorrow's Company has played a key role). Another is the Kay Review, looking at the operation of the investment chain. At company level a pioneering report by the German sports apparel company Puma has recently calculated and reported on the cost of carbon and water in its entire supply chain which indicates an additional business cost of approximately €100 million as against the established measurement model currently in use. Many financial institutions are welcoming the UK's Stewardship Code and a group of asset owners and fund managers have set out a framework for improving the quality of investor stewardship.

The aims of the *Tomorrow's Finance* programme

The aim of this programme is to provide a platform for radical ideas for how the financial system should evolve in the future to the benefit of savers, companies and the wider society – ideas which can help address the shortcomings of the system we have today, create a new architecture for the institutions required to fulfil business and societies' needs over the coming decades and ensure the financial industry is seen as a force for good.

The ambition is to identify the key game changers, ones that the industry, business and those in the regulatory community can focus on in effecting change. This identification will be central to creating the relationships of trust that are needed between the financial system and society and on which future social and economic stability can be built. For example the programme will try to unearth progressive ideas around:

- how the needs of asset owners can be better aligned to the functioning of the financial system
- how fiduciary duties can be strengthened across the investment value chain
- where should the financial industry take the lead in responding to the largest challenges facing society
- where, and through what mechanisms can regulation play a part in effecting radical change.

A central theme of the programme will be a focus on the impact of culture, values and behaviours on the ability of the system to optimise its position as a central enabler of wealth creation.

Tomorrow's Company and MAM Funds plc thank the authors of this brochure, Philip Sadler and David Phillips. Philip Sadler CBE, is senior fellow of Tomorrow's Company, he was chief executive of Ashridge Business School for 20 years and is now a life vice president. David Phillips is a trustee of Tomorrow's Company and previously senior corporate reporting partner at PwC.

The *Tomorrow's Finance* debate will complement other Tomorrow's Company programmes of work with the business and investment community:

- in 2004 the inquiry *Restoring Trust-Investment in the 21st Century* convened a number of leading figures in the financial services industry to examine the effectiveness of the investment system and to put forward proposals for its improvement
- this was followed by *Tomorrow's Owners*, a study of the different forms of ownership of companies and their implications for sustainability
- more recently a report on *Tomorrow's Corporate Reporting* was produced in association with PwC and CIMA
- a project on *Tomorrow's Stewardship Economy*, in association with UNEP and Aviva Investors is nearing completion
- currently there is an ongoing series of lecture/debates on *Tomorrow's Value*, also in partnership with CIMA
- there is also a programme in association with Russell Investments, UN PRI and others called *Tomorrow's Value: Achieving sustainable financial value* which looks into changing the way in which we think about value along the investment chain.

About MAM Funds plc

MAM Funds plc is the parent company of a fund management group trading under Midas Capital Partners and Miton Asset Management, with a stable of fund brands – Miton, Midas and Acuim. We have a range of multi asset and single strategy funds. We are primarily asset allocators, driven by a top down approach to investing. The advantage of starting from a macro perspective, we believe, is that shifts in government policy, interest rates etc. will in turn affect financial instruments such as equities, bonds or currencies. By anticipating changes in the global economic outlook and identifying the key drivers of markets we believe that over the longer term we can enhance the returns for investors throughout a variety of market and economic conditions. Very often we notice themes or trends emerging and aim to get ahead of these trends. We believe that fund managers will need to demonstrate a willingness to think more independently in future. We believe that each investment selection should be made on its absolute potential together with an understanding of its true underlying value. In more challenging markets we believe that these kinds of independent thought and stock selection skills will become more important in generating attractive returns for clients.

www.mamfundsplc.com

About Tomorrow's Company

Tomorrow's Company is the agenda setting 'think and do' tank which looks at the role of business and how to achieve enduring business success. We focus on strong relationships, clear purpose and values as the foundation of effective leadership and governance. In our programmes we challenge business leaders around the world to work in dialogue with others to tackle the toughest issues. We promote systemic solutions, working across boundaries between business, investors, government and society. We believe that business can and must be a 'force for good'. This in turn requires a strengthening of stewardship by shareholders in partnership with boards of companies. We argue that the Age of Sustainability has begun, and that in the future success and value creation will come from recognising the 'triple context' – the links between the economic, social and environmental sub-systems on which we all depend, and the opportunities this brings.

www.tomorrowscompany.com
Follow Tony Manwaring on Twitter at: **www.twitter.com/tonymanwaring**

About Slow Finance

Slow Finance by Gervais Williams focusses on the types of businesses that banks and other financial institutions should finance, the criteria they should adopt and above all the nature of the relationships which can best secure long-term returns – such as exploring in depth financing for food production and other areas vital for economic prosperity and future wellbeing.

To order the book and use the app: **www.slowfinance.com**

Join the debate on:

www.tomorrowsfinance.co.uk

hosted on forceforgood.com

Tomorrow's Company in partnership with MAM Funds plc

supported by:

LONG FINANCE

Centre for Tomorrow's Company
Charity registration number 1055908.
Registered office: Samuel House
6 St Alban's Street, London SW1Y 4SQ.

ISBN 978-0-9565265-8-8

9 780956 526588 >

£10 Institutions/Organisations
£5 Individuals/Members/Reduced
(including p&p)

FSC
www.fsc.org
RECYCLED
Paper made from recycled material
FSC® C022913

The paper used in this publication is 100% post consumer reclaimed material, certified in accordance with FSC® (Forest Stewardship Council), reducing the impact of landfill and energy consumption

Designed and produced by studio401