New City Initiative

Alignment of interests: fixing a broken City

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The NCI is a think tank whose members are some of the leading independent asset management firms in the City. Founded in May 2010 at the initiative of Daniel Pinto, Chairman and co-founder of Stanhope Capital, NCI aims at giving a voice to the many City entrepreneurs who have created highly successful businesses by remaining entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, this old fashioned "client-centric" approach has enabled entrepreneurial firms in the Square Mile and beyond to emerge as a growing force in a City dominated by global financial giants, thereby playing a key role in maintaining London's position as the most dynamic financial centre in the world.

We at NCI believe that regulators, government officials and industry participants have to be able to work together in a dispassionate atmosphere to bring about the structural reforms required to strengthen the sector as a whole and avoid another crisis of confidence. The NCI aims at becoming the forum of choice for these discussions.

Published by the New City Initiative in 2010

ISBN: 978-1-907188-43-5

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Contents

The New City Initiative i

Why alignment is Important 1

Reversing some of the trends of the last decade 1

What can be done? 2

Conclusion 6

The New City Initiative

The NCI brings together a group of privately-owned wealth and fund managers that have a track record of driving innovation and high standards in this key section of the country's financial landscape. Collectively, this group manages approximately £150 billion and employs several thousand staff. We form part of the essential bridge between savers and investors on one hand and, on the other, the many wealth and employment creating companies that are dependent on external investment for their success.

Our focus is naturally on highlighting our collective experience of what works in our own industry sector, what will ensure its continued success, and what will harm it, but we believe the same principles and lessons will also have relevance to other types of City institution, to which we are bound by our many overlapping interests and a shared reputation.

A central part of our function is the management of financial risk on behalf of clients. Risk is an inherent factor in the investment process, and it is risk that helps bring about the efficient allocation of the nation's capital to the most productive and wealth-generating companies and activities. This provides benefits to both government and society as a whole. However while risk-taking in its many forms is the engine of economic growth, to be a force for good it must be managed appropriately, professionally and ethically.

The recent financial crisis has led to renewed focus on curbing what many have regarded as excessive risk-taking in specific areas by financial managers. The reputation of the City has been damaged by recent events, and its governance and actions are under unprecedented scrutiny. We aim to become an active participant in the resulting discussions over the coming months.

Regulation has an essential role of course, and we welcome and benefit from appropriate and effective regulation. However members of the NCI do not believe that the prescriptive drift in the current reform debate will impact effectively upon excessive risk taking.

Therefore above and beyond reviews of regulation we believe that there is a need to address the culture and guiding principles by which financial services companies operate. In other words, the starting point for tackling perceived excess should be the reinvigoration of some basic principles of good governance.

We focus here on one core principle, the desirability of 'alignment of interest' between market participants. This is a tool which can limit the likelihood of making bad investment decisions which harm individual savers and the financial system in general.

Why alignment is important

Alignment of interests plays an important role at several levels:

a) Between investment managers and their clients, to ensure that the former are driven by the long term interests of the latter and not by the urge to make a quick profit at the latter's risk; where rewards are shared but the risks are borne only by the investor there is fertile ground for those inclined to take thoughtless risks.

b) Between the senior managers of financial institutions and their shareholders, where they are not the same, in order to ensure that key decision makers behave like responsible owners of firms that are systemically significant.

c) Between the management of companies receiving investment and the investors and fund managers that provide their capital.

The creation of aligned interests has long been a recognised facet of industry best practice, but it is a long way from being universal practice. Addressing this problem is fundamental to the long term vitality and reputation of our industry. Where such alignment can be achieved, there exists an inherent safeguard against inappropriate risk-taking. It is a stronger and more effective safeguard than regulation alone can achieve.

The goal of creating greater alignment of interests should be more prominent in the continuing debate and in the reforms which are to come.

Reversing some of the trends of the last decade

Over the last decade, a unique set of circumstances has created an environment geared towards institutional and individual risk-taking on a scale never seen before. The exponential growth of the market for derivatives of all kinds, the unprecedented availability of plentiful and inexpensive debt, the payment of financial rewards based on short term performance, structural and behavioural changes in the industry: underpinned and encouraged by regulatory changes and government connivance, all these combined to make the 2008 financial meltdown possible.

We do not here seek to dissect every cause of the financial crisis. In the context of alignment of interest we highlight three structural shifts that have combined to put distance between investment professionals and their clients:

- Many of the partnerships that used to dominate the City and Wall Street have either disappeared or have become large public companies where the top decision makers are at best small shareholders. The old partnerships used to pride themselves on the prudent deployment of their capital and their focus on clients. The new financial giants have used their larger capital bases as tools to borrow ever-increasing amounts of money to pursue riskier activities, often on their own books. The business of advising clients has become relatively peripheral to other activities.

- Many financial advisers have become product distributors. The search for higher margins has driven many institutions to transform their financial advisory activities into product distribution channels without even clearly disclosing this shift to clients. In addition to the many conflicts of interests resulting from this blurring of the lines between the two roles, asset managers have too often ceased to co-invest in any meaningful way alongside their clients. Most damaging of all, firms are both principal and agent in deals, without this being transparent to their clients.

- The incentives of market participants have become excessively focused on short term performance. Bonuses paid by banks to their staff, and performance fees paid by investors to asset managers, are frequently based on results achieved over periods which are too short to be truly meaningful.

NCI members can seek to develop and implement best practice but cannot reverse these fundamental trends on our own. Our goal is to make suggestions likely to help in rebuilding the bridge of trust between investment professionals and their clients. We believe that safeguarding certain key principles is not just right, but also good for business.

What can be done?

1. Co-investment by asset managers: practice and disclosure

Co-investment means that the owners of fund management and investment advisory firms, and the fund managers running the funds and taking the decisions, are directly investing their own assets in line with those of their clients. In many other areas of commerce the principle of 'caveat emptor' can reasonably apply, but there is no reliable or objective way for clients to appraise future investment decisions at the time they commit funds, so the principle of co-investment has a special significance and status in this context.

Moreover, attempts to help investors make informed decisions about their investment choices through greater disclosure have been only partially successful. Investors have lost confidence in investment managers and the City as a whole. We can begin to rebuild trust by putting our money where our mouths are and making a financial commitment alongside our clients in the investment products we wish them to buy.

To be meaningful co-investment needs to be carried out in a systematic manner. This implies organisational policies which lend themselves to alignment of interest, and which restrict the scope to pick and choose where alignment can operate and where it is put aside. It implies holding a significant portion of managers' assets alongside those of their clients. Where that is impossible or impracticable it implies holding a significant portion of accumulated conditional rewards (performance fees and bonuses) alongside the funds of clients.

In practice a willingness to adopt this approach is now found mainly amongst the various forms of owner-managed firms ('OMFs'). These tend to maintain more of the

spirit and ethos of the old pre-LLP partnerships, having a characteristically strong emphasis on individual responsibility, specialist focus, transparency, prudence and client orientation.

Regulation cannot predefine every circumstance but it can influence the environment in which client discussions take place, at root simply by making more information available. There is currently a requirement for managers to disclose their fee structures, but no such requirement that they should disclose the extent of their investment in their own funds. The nature and extent of professional disclosure by investment managers and advisers should be the subject of review and debate going forward. Government reviews should address a possible requirement for disclosure of whether or not fund managers are significantly invested in the funds they manage.

More often than not the answer to any such question about extent of alignment will be 'none at all' and that must be a permissible response. It is nonetheless useful information relevant to investor choices. Its regular restatement would over time influence discussion and therefore behaviour.

It is important also to guard against regulations which impede beneficial practices such as co-investment. For example, the 'Investment Management Exemption' creates a 20 per cent cap on the proportion of a fund being owned by the fund manager. In certain types of fund this will be a sensible rule, but in funds targeting niche and highly specialised investments, the total investments involved may be smaller and a successful manager can quite quickly reach this ceiling. Forced disinvestment to follow a rule put in place for a different purpose is not appropriate in such cases.

2. Compensation as a tool for greater alignment

Bonuses

The current public and political preoccupation with bankers' bonuses is entirely understandable given recent history, but it is important that attempts to influence or regulate these arrangements have a regard for what it is that we should be trying to achieve. An increasingly common suggestion for curbing excessive bonuses, leaving aside direct taxation, is to delay payments and provide such bonuses mainly or entirely in the form of share options rather than cash. The recent EU proposals are the latest in this line. It is said that this helps address short-termism. However in reality this does nothing to achieve real alignment of interest and ironically may even exacerbate separation of interest in such institutions.

This is because stock and stock options are too distant from the daily decisions being made on behalf of clients. The actions of most individual managers in the large institutions have little or no significant influence on their firms' share prices and therefore on the value of their stock options. Instead it leaves them, as under a cash bonus regime, every incentive to maximise their annual entitlements by maximising the risks to which client funds can permissibly be exposed.

The conversion of bonuses from cash to share options addresses what we recognise has become a political imperative, but the more fundamental aim should be to disincentivise disproportionate risk taking. This means altering the criteria for bonuses rather than disguising them or even simply fanning resentment toward their existence.

The now longstanding drift away from co-investment and other forms of alignment is a cultural issue in the larger banks; it is a habit more than an inevitability, and habits are not immutable. Our view is that any new measures should aim to reengineer the linkages between the performance of specialist teams within advisory institutions and the remuneration of those teams.

Regulators should recognise that curbing excessive risk is a slippery target for prescription and that in that task the linkage of bonus and client is more important than that between bonus and share price of the employing firm. The former strengthens alignment of interest; the latter may actually weaken it. The former creates shared risk sensitivity; the latter all but eliminates it.

The management and boards of financial institutions, and particularly their remuneration committees, should be much more transparent with regard to the parameters used to incentivise teams, and should be made more directly accountable for their recommendations.

Performance Fees

A typical hedge fund and private equity practice is to charge a management fee of 1 per cent to 2 per cent of assets under management, plus a performance fee which is typically up to 20 per cent of gain above a threshold. Performance will usually be an annual judgement, the consequences of which are clear. If successful the manager is rewarded; if unsuccessful he or she does not – unless various other criteria are written into the funds' policies – lose any fees previously gained. In the absence of meaningful co-investment, the asymmetry of performance fees generates an inherent incentive to take higher risks.

Many companies, NCI members included, operate such fee structures. They do so openly, and clients are aware of this and agree to the fees. What prevents asymmetry of risk, however, is proper alignment of interests with their clients. If there is co-investment then managers share fully in the same risks as investors and savers. It is "their pension too". And that makes for better investment decisions.

Circumstances vary enormously in the detail and so the precise structures required to achieve integration of performance fees, co-investment and alignment of interest will necessarily vary from case to case. For example, performance fees can be retained to build up a manager's commitment to his or her fund. Meanwhile the competition for highly paid talent puts pressure on employers to adopt performance fee structures. Prescriptive regulation is unlikely to be helpful in this context, hence our primary emphasis on disclosure to promote better practice through greater awareness.

3. Encouraging the Owner-Manager Model

Achieving meaningful alignment often has an organisational underpinning. We believe that OMFs have a more natural affinity for aligned investment approaches. These tend to maintain a characteristically strong emphasis on individually identifiable responsibility, specialist focus, transparency, prudence and client orientation.

Within such organisations there is a direct and immediately discernable link between the results of the investment strategies adopted and the overall results of the management company. Alignment of interest is more likely to be accepted by managers, and more easily achieved. There are many examples of its successful operation amongst NCI members, and they will of course continue to promote the benefits of their own approaches to potential clients.

However we are all also impacted by the reputation of the City as a whole. The last round of major regulatory reform, in the 1980s, favoured the larger, full service financial model. It is time to readjust that balance and we would prefer to see alignment of interest more widely re-established across the City and particularly across the financial services industry.

For while examples of genuine co-investment can be found in the larger investment banks, it is now exceptional. The trend within the major banks over the last 25 years has been towards greater centralisation of management and reward, and a dilution of alignment with clients. The reward structures for individual managers have become more dissociated from their clients, typically linked instead to discretionary bonuses based more on the performance of a broader team or of the entire firm, or, in the worst case, on fee generation.

Reinvigorating an owner-manager culture within large organisations should be a priority if we are to change behaviour in the City. And the maintenance of London as the pre-eminent financial centre depends also on regulators fostering a climate of entrepreneurialism and innovation in preference to the protection of entrenched interests. The balance is at present tilted toward the larger players.

This means that new regulations should not target all market participants in a blanket approach. Proper attention should be paid to the size of firms involved and their systemic significance, to the nature of their activities and the real degree of risk involved.

The recently announced UK FSA plans to implement EU rule changes on remuneration are a case in point, and we intend to respond to the consultation on these proposals separately in more detail. However in essence it is clear that these proposals impact disproportionately on smaller firms and are inconsistent with the FSA's stated aim of making remuneration more consistent with effective risk management. We are concerned that far from reducing systemic risk, aspects of these proposals may inadvertently weaken those firms which help to disperse it.

Conclusion

In summary, the NCI believes that more widespread and effective alignment of risk and reward between investment managers/advisers and their clients will bring mutual benefits to investors and the industry as a whole.

We encourage managers and advisers to align their interests with those of their clients, through co-investment and/or remuneration based on longer-term performance measures when appropriate.

We do not believe this should be the subject of prescriptive regulation, but rather that alignment should be encouraged to evolve within a regulatory framework which requires disclosure. We urge policymakers to promote this through more comprehensive disclosure requirements, as well as other regulatory and/or fiscal incentives.

We believe that regulators should promote the owner-managed model as the best positioned to foster alignment of interest.

We consider that regulatory measures should not target all market participants in an undiscriminating approach. Proper attention should be paid to the size and systemic significance of the firms in question, the nature of their activities and the actual degree of risk involved.

Finally, we undertake as a grouping of like-minded institutions to be at the forefront of this initiative to restore to our industry the principles of transparency, long-termism and trust.

New City Initiative

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Incorporated in England & Wales as a private company limited by guarantee,
registered office as above, company registration number 7250381

ISBN 978-1-907188-43-5

produced by codexbilingua job no. 9315

www.codexbilingua.com