New City Initiative

Start up Britain is here in London: why it is crucial to support financial SMEs

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The NCI is a think tank whose members are some of the City's leading wealth and asset management firms. Founded in May 2010 at the initiative of Daniel Pinto, Chairman and co-founder of Stanhope Capital, the NCI aims to articulate the views of the many City entrepreneurs who have set up businesses whose success rests upon remaining entirely focused on and aligned with the interests of their 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 the NCI have undertaken a series of meetings with senior regulators, government officials and industry participants, with the aim of working together in a dispassionate atmosphere. Our first aim is to develop solutions to make the financial system safer both through better regulation and also by encouraging greater alignment of interests between City decision-makers and their clients. Secondly, we aim to be a source of ideas and initiatives on ways of rebuilding the bridges between the City and society at large. We believe that the financial SME sector benefits the system from the bottom up through better risk management, diversity and innovation.

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The Background

The impetus for this paper arose in a most unlikely manner. At a meeting with the NCI, the Business Secretary Dr. Vince Cable asked about the scale of small and medium sized financial services businesses, and how many jobs this sector provided, in the capital. Nobody had the answer. The Board of the New City Initiative promised to find out and to report back to the Secretary of State. With the significant assistance of IMAS Corporate Advisors and the Lord Mayor's office, we delved into the data, and found that this interesting question revealed some surprising statistics. We therefore thank the Business Secretary for inadvertently initiating our latest policy paper, which we hope will fill some gaps in knowledge about this robust and thriving section of the financial services sector in the UK (and indeed by inference in Europe more widely). As this paper will demonstrate, the so-called "City" is far from being about the financial giants alone.

Taxpayers were called upon to bail out 'big banks' after the financial crisis, leading many voters to resent the financial services industry bitterly. But there is another City. It is made up of entrepreneurs who manage significant sums on behalf of investors and employ many tens of thousands of people. Some of us have come together to form the NCI, whose members alone have some £200 billion under management and employ several thousand individuals.

However we represent but a small part of the diverse body of financial SMEs that contribute to the City. According to our research sources, the financial SME sector (typically defined as firms employing less than 250 employees) as a whole employs up to an astonishing 57 per cent of the UK's total financial services staff. Accurate figures for assets under management are harder to come by, but the UK's Financial Services Authority (FSA) suggests that UK-based hedge funds alone manage some $550 billion.[1] In Europe as a whole, it is estimated that the hedge fund industry – just one category of the SME sector – employs 50,000 people across the EU, and that their partners, employees, consultants and service providers pay taxes of more than $8 billion every year.[2] Clearly this is just the beginning as far as the wider financial SME sector is concerned across Europe.

We believe that financial entrepreneurs are a valuable asset for the UK and wider EU at a time when economic growth, particularly outside the European core, cannot be taken for granted. Given the rise of emerging economies and the pressing need for developed nations to compete, SMEs are vital because they stimulate excellence and hence competitiveness within the financial services sector.

In the light of financial SMEs' significant roles as employers and innovators, as discussed further below, we believe that there is a vital need for regulators to ensure that the new

[1] FSA: A Report on the Findings of the Hedge Fund Survey, July 2011
[2] Alternative Investment Management Association Newsletter, "The Global Hedge Fund Industry", March 2011

regulatory framework distinguishes between different kinds of financial businesses with a particular focus on the levels of risks they may (or may not) create for the financial system. This will help the City and financial centres throughout Europe to thrive as valuable economic assets for their own countries and for the EU more widely. The alternative is to expose Europe's financial centres to avoidable competition from offshore regimes such as those in Switzerland and many emerging markets, where the authorities aim to attract institutions through lighter regulatory and tax burdens.

This paper covers lots of ground, but it focuses on one key point. **We must avoid imposing regulations designed for banks and shadow banks on SMEs.**

The first step towards this is to correct the misconception – common in policymaking and regulatory circles in both the UK and Europe more widely – that the financial sector consists solely of big banks. When regulators and other officials deal with financial services companies, they must distinguish between two categories. The first includes those businesses which use their balance sheets for trading purposes. The second is comprised of companies that do not – which are, effectively, third-party advisers – and which also demonstrate a strong focus on alignment with their clients. The UK government set out its commitment to small businesses of all industries in its budget of March 2011, although many would argue that its proposals did not go far enough. With this principle established, we would like to see measures taken to encourage SMEs in the financial services sector specifically, based on the key distinction identified above.

What financial SMEs are and why they are significant

Small and medium enterprises (SMEs), as defined in this paper, are financial businesses which employ up to a few hundred people. Unlike many big banks, the financial SMEs to which we refer never trade on their own balance sheets. Crucially, the owners of financial SMEs manage the businesses.

Financial SMEs make important contributions in a number of areas. Some of their core strengths can be summarised as follows:

1. They are significant employers;
2. They are not systemically risky for financial markets;
3. The owners' interests are aligned with those of the investors;
4. They set an example of best practice in manager remuneration and alignment;
5. They innovate in the provision of financial services;
6. They are champions of diversity;
7. They are generous donors to charitable organisations and institutions;
8. They have historically generated superior investment returns; and
9. They increase competition within financial services.

1. **Why financial SMEs matter for employment**

   As discussed above, SMEs are important because they create jobs. According to studies from IMAS, TheCityUK, the Department for Business, Innovation and Skills, and the National Institute of Economic and Social Research, SMEs employ between 300,000 and 569,000 of the approximately one million workers in Britain's financial services industry.[3] SMEs increased employment of financial approved persons (APs) by 16 per cent from 10,272 in 2007 to 11,927 in 2009. That contrasted with a 5 per cent fall in APs employed by large companies during the same period (from 20,229 in 2007 to 19,176 in 2009). This tale of two sectors is significant because it demonstrates the ability of SMEs to create jobs even during a period which included the financial crisis.

2. **Taxpayers do not have to bail out SMEs**

   Unlike the large banks and shadow banks, financial SMEs present no systemic risk to our financial foundations. We welcome the Financial Services Authority's 'proportional' approach and recognition that SMEs are in the lowest category of systemic risk. There is no significant danger that they could require a bail-out by taxpayers because they do not trade on their balance sheets.

3. **The owners of financial SMEs still manage their firms and advise their clients**

   Because financial SMEs are owner-managed, they avoid many of the problems which arise when the shareholders of big financial companies cannot control what the directors do. This 'agency problem' caused huge public dissatisfaction by creating conditions in which executives at the big banks could pay themselves bonuses that were very often not justified by the quality of their work. The agency problem has also been a matter of serious concern to policymakers including Dr. Cable, the Business Secretary. Managers who own their firms have every incentive to devote their absolute focus to the businesses and funds where they have invested their own money.

4. **They lead the way in manager remuneration and alignment**

   As addressed in our first policy paper: ***Alignment of interests: Fixing a broken City***, managers in large financial institutions are often not well aligned with their clients in respect of remuneration. Too often variable remuneration is based on short term performance metrics, and alignment achieved through the flawed method of share option issuance. Ironically, the revision of the Remuneration Code late last year pushed large firms to raise base salaries and reduce the performance-related component of pay altogether. Moreover, managers are not typically required to invest alongside their clients in the products which they have devised or recommended. Performance-related fees create an asymmetric payoff: if a manager is successful one year, he or she is rewarded; if unsuccessful the next year, he or she does not typically lose any fees previously gained.

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[3] Between one third and one half of the employees in Britain's financial services industry work in this sector, according to a study by IMAS Corporate Advisers. They employ no fewer than 350,000, and up to 569,000, of the 1 million workers in the UK's financial sector (The CityUK and BIS statistics). Separate analysis, based on data from the National Institute for Economic and Social Research, estimated the level of SME financial employment at between 300,000 and 569,000. Further detail about the role of financial SMEs in creating jobs is available from the study by IMAS at www.newcityinitiative.org

The situation is typically very different in SMEs where owners are not just incentivised as shareholders but also as investors in their own products because there is a far greater emphasis on co-investment in funds managed. There is consequently a significantly more direct linkage between the risks taken by both client and manager. Moreover, for those awarded equity in SMEs, their own performance will frequently have a significantly more direct effect on the prospects for the firm as a whole than would be the case in a large organisation. Many companies, including NCI members, use performance fee structures. Clients understand this and agree to them. However the difference is in the level of co-investment. If this is meaningful, then managers share the same risks as their investors and savers. This leads directly to better investment decisions. By contrast, because bigger firms do not use co-investment significantly, their managers have an incentive to take higher risks.

5. Financial SMEs innovate in the provision of financial services

SMEs have long been the drivers of innovation within the financial services industry. Often set up by those who have become dissatisfied with the sense of status quo which exists in many larger organisations, SMEs frequently provide a platform for those whose creativity and entrepreneurialism steers them away from larger, more corporate entities.

A.W. Jones set up the first hedge fund in the US in 1949. He was reacting to the limitations of bigger firms, which failed to align their interests sufficiently with investors and which he felt focused too much on performing relative to an index, instead of making money in absolute terms. Hedge funds were for many years a distinct business, practiced by small partnerships. However in more recent years many of the principles of those pioneering hedge funds, from a focus on absolute returns and even to powers to hedge positions under UCITS 3 regulations, have entered the lexicon of the larger investment management houses.

Another example of an innovation derived from SMEs which has improved the competitiveness of larger firms is in the wealth management space. Multi-family offices, so called on account of their evolution from family roots and increasingly now known as private investment offices, are investment firms which advise families, charities, and endowments. They were pioneers of ‘open architecture’ investing, according to which investment advisers select best of breed managers for their clients’ funds, rather than simply selling in-house funds and other financial products. The beneficial effect of this has been to force larger competitors in the wealth management sector to become much more independent when they choose managers with whom to invest their clients’ funds, although there is still much progress to be made in this area.

6. Diversity – a tale of two sectors

Financial SMEs need to be lean, efficient organisations. They simply cannot afford not to employ the best talent, regardless of background. To this end, the NCI in July 2011

ran an internship scheme designed for those without contacts in the City. Twenty students became actively involved in the work of our member firms. None of the undergraduates rated the programme less than four out of five in the anonymous exit review. The project won the personal support both of David Willetts MP, the Minister for Universities and Science, and of Dr. Vince Cable MP at the Department for Business, Innovation and Skills.

7. The City's entrepreneurs fund schools, hospitals and charities

Financial SMEs are often populated by businessmen with a vision for society. Some of the best examples are current or former fund managers who have given money and time to charities. These donations and commitment are particularly significant at a time when the difficult economic climate is putting pressure on the voluntary sector. The provider of one of Britain's biggest ever charitable donations was Chris Cooper-Hohn, the manager of TCI who, gave £499 million in 2008, according to the Charity Commission, following on from a donation of £323 million the previous year. TCI gives a proportion of its fees and profits to the related charity, the Children's Investment Fund Foundation (CIFF), which aims to improve demonstrably the lives of poor children in the developing world. Although it was set up as recently as March 2002, the charity has long-term investments of £2.1 billion, according to its latest accounts.

Ark (Absolute Return for Kids), a children's charity set up by Arpad Busson, founder of EIM Group, has donated more than £140 million over its lifetime to children's charities, according to the trustees' latest report. Ark Schools runs eight academies and aims to have 12 fully operational by 2012. Almost half of the pupils at Ark secondary schools are on free school meals. Its vision is to make sure pupils from disadvantaged backgrounds achieve their potential, a passion which every parent, and many others, share. That vision is beginning to happen. In 2010, 51 per cent of pupils gained five GCSEs including English and Maths, compared with 20 per cent at the same schools in 2006, the year when Ark's first academy opened.

Others give generously of their time as well as money. Paul Ruddock, the chief executive of Lansdowne Partners, became Chairman of the Victoria & Albert Museum in July 2007. Since then he has helped raise over £120 million for the museum. He spends at least ten hours a week of his own time on the V & A, according to his personal website.

Such businessmen take a results-based approach to the charities which they found and fund. CIFF, for example, expects significant improvements from its projects in exchange for continued financing. This marriage of a vision for society with a businesslike insistence on detailed improvements brings results, as demonstrated by the improved life chances of pupils at Ark secondary schools.

The individuals mentioned above are just illustrations of a major trend in the world of financial SMEs. Those who have been successful are keen to give back to their community.

8. **Financial SMEs have done better for their clients**

Firms in which employees own a significant share of the equity have outperformed those without, according to a statistical analysis released by Hymans Robertson, the consultancy.[4] The relationship between returns and ownership could not be explained by chance. The consultants studied approximately 500 equity and bond funds, run by more than 200 managers, from 2006 to 2010, a challenging period which included the recent financial crisis and the sharp recovery in risk assets thereafter. Hymans Robertson studied the top quartile of management firms, where employees owned the highest proportion of equity. That group outperformed the bottom quartile, where employees owned the lowest proportion of equity, by more than one percentage point per year over three years.

9. **They increase competitiveness within the sector**

In terms of scale and assets under management, the financial services industry can often seem to be dominated by an oligopoly of large integrated banks and investment management houses. The competition provided by smaller independent firms clearly benefits consumers in all areas of financial services.

Policy response 1: Encouraging financial SMEs

The owner-managers of SMEs are entrepreneurs who have demonstrated considerable success in the areas identified above. They do not want crutches; however they equally do not deserve unnecessary hindrances. It is an irony that policymakers have not treated financial SMEs as a distinct sector, despite the benefits which they bring to the financial services sector and the economy as a whole. An exception came after a debate (in which the NCI was closely involved) in which the FSA chose to exempt SMEs from the Remuneration Code under the principle of proportionality. We welcome the FSA's recognition that SMEs fall within the lowest category of systemic risk.

Financial SMEs play a major role in the City, one of the EU's major economic assets. Given their importance to the economy, the NCI would welcome a wider application of proportionality in the areas of regulation and legislation. **We propose that policymakers should habitually utilise twin-track processes which would ensure that SMEs in all sectors benefit from treatment proportional both to their individual means and to the systemic risks that they pose.** The change would extend the European Commission's welcome adoption of the Think Small First principle.[5] It would require that legislators take the interests of SMEs into account at the very first stages of policy making.

1. **Reducing the cost of regulation**

Once upon a time, regulators dealt with financial workers on the basis that the spirit of the regulation is at least as important as the letter. This assumed that executives always act responsibly by using their judgement about what the spirit of the rules

[4] Identifying Predictive Factors in Manager Selection: Hymans Robertson, April 2011

[5] See further http://ec.europa.eu/enterprise/policies/sme/small-business-act/think-small-first/

requires. The last few years have vividly illustrated the fallacy in this assumption. It is unsurprising that executives who are improperly aligned with their clients – both at business and product level – will often fail to make decisions which prioritise the long-term interests of those clients (not to mention of their employers).

However, financial SMEs do not share this characteristic. The managers of independent firms are their owners. They often have most or materially all their personal wealth invested in their businesses. There is a clear difference between the manager in a major banking conglomerate who must be prevented from taking excessive risks in the pursuit of short-term performance by a rigorous system of rules and checks, and the owner-manager of a financial SME where risk aversion is endemic to his very relationship with the firm.

Compliance has become a debilitating cost for the City's entrepreneurs. Eight years ago, the annual cost of complying with regulation was not considered onerous by members of the NCI. The opposite is now true. NCI members surveyed for this paper have reported that the direct and indirect costs of compliance amount on average to some five per cent of their total revenues. To put this in perspective, were this to hold true across the whole financial services industry in the UK, this would account for approximately 0.5 per cent of the country's entire GDP.

The Financial Services Compensation Scheme (FSCS) has also imposed particularly high costs on NCI members. The unpredictable nature of this outgoing is an entrepreneur's nightmare. We would welcome a reduction and smoothing in this cost for financial SMEs.

Clearly, appropriate regulation is necessary and desirable. However, regulation must be proportionate to the risks posed by particular firms. The NCI believes that in this area, regulators should apply two crucial tests. Does the company trade on its balance sheet? And how well aligned are the managers with the business and its clients?

2. Motivating employees

City entrepreneurs want to hire the most talented individuals, irrespective of background. The NCI internship scheme, as discussed above, is a tangible example of this. However even in that instance we encountered significant difficulties with processing national insurance contributions for the interns. We want to work with officials to solve such problems.

Firms naturally want to motivate all their staff. This is critical both to the quality of service delivered and ultimately to profitability. One highly effective way to engage staff members is to grant meaningful equity participation. Employees who have significant equity and are consulted are more likely to excel. Employees of the John Lewis Partnership, for example, stay with the business twice as long, on average, as other high-street workers, while either the department store chain or Waitrose are regularly named as the UK's favourite shop by the Which? consumer organisation, according to an article published last year in the *Guardian* newspaper.[6] The founder of one financial SME within the NCI wanted to give equity to every employee of the

[6] http://www.guardian.co.uk/commentisfree/2010/mar/11/john-lewis-profit-happiness-employees

firm, but found this impossible for tax reasons. (The firm in question is a partnership, and making each member of staff a partner would have required them to pay different national insurance contributions, and to prepare self-employed accounts.) This is a missed opportunity. Entrepreneurs should be able to empower their colleagues, from receptionists to senior managers, with the commercial energy that only comes from ownership and alignment.

Policy response 2: Incentivising co-investment

It is an understatement to say that the financial services industry is not at its most popular after the recent crisis – and in many cases, justifiably so. However, we believe that financial SMEs have been unfairly tarred with the same brush as larger firms which are either unwilling or unable to align themselves properly with their clients. There is a strong incentive for all sides to correct this misperception: with the phasing out of final salary pension arrangements, ministers have encouraged voters to invest for their pensions and there is a public policy imperative in restoring trust in the investment management industry. The restoration of trust requires eating our own cooking, to paraphrase Warren Buffett. Managers must be incentivised to invest alongside savers. Managers who put their own money into their products are far less likely to be reckless. No saver should entrust his life savings to a manager who does not invest his or her own assets in the same fund, or at least management firm.

Policymakers can help by creating incentives for individuals at asset management firms and banks to invest significant proportions of their earnings for the long term. For example, there should be incentives for staff members who re-invest, for a minimum holding period, their salaries (or drawings) in investment funds which are sold to third-party investors. These incentives could take the form of favourable treatment of tax on investments within managed funds, or on income which is directly so invested. As an exercise in behavioural economics it is bound to deter short-term risk-taking, and over time to restore individual investors' faith in the industry.

Conclusion

Financial SMEs are one of the best-kept secrets in the City and the EU more widely. They pay billions of pounds and euros in taxes and employ hundreds of thousands of people across the continent.

Policymakers have long been concerned about the risks posed by big banks. However, we must not allow these risks to colour our thinking about all financial services companies. We should remember the demonstrable ability of financial SMEs to create jobs, to contribute to economic growth, to pay taxes, to fund charities and to generate financial innovation which benefits investors.

The NCI would welcome proportionate regulation, affordable legislation, and incentives for co-investment, such that financial SMEs can regain the trust of the public and continue to be at the forefront of good practice in the financial services industry.

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