Supporting UK Productivity with Long-Term Investment

The Investment Association's Productivity Action Plan

March 2016

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FOREWORD

Guy Sears
Interim Chief Executive
The Investment Association

THE INVESTMENT INDUSTRY PLAYS A CRITICAL ROLE IN THE ECONOMY, AS THE CONDUIT THROUGH WHICH MONEY MOVES FROM SAVERS TO BUSINESSES. WE RECOGNISE THAT THIS IS AN IMPORTANT ROLE, PUTTING US IN A SPECIAL POSITION TO BE ABLE TO IMPROVE OUR NATION'S ECONOMY. THE GOVERNMENT'S AMBITION IS THAT BRITAIN BECOMES THE RICHEST OF THE MAJOR ECONOMIES BY 2030, WITH THE HOPE THAT OUR CHILDREN'S LIVES WILL BE BETTER THAN OUR OWN.

But we can only achieve a more prosperous Britain for all if we are able to tackle the UK's productivity problem. It is a chronic issue. Productivity growth in the UK remains 16 percent below its pre-2008 trend rate. In the long term, lower productivity can only mean lower wages, lower living standards and a less competitive economy. Crucially, it also means lower rates of return for the investors our industry serves on a day-to-day basis. That is why we agree with the Government that now is the time to act, and we are committed to using our investment industry's unique role in the economy to enact reforms that can improve our economy for all.

The Action Plan outlines how we as investors can play a fundamental role in rebuilding the UK's economic foundations for a better future. As the Introduction records its genesis was from leading members of the industry; and the published Action Plan is the product of hours of work by some of the brightest minds in the British investment industry and wider economy.

We call for a series of targeted and significant reforms to the way different parts of the economy communicate with each other, so as to give companies the confidence to invest their capital in productive enterprises. Most of all, the Action Plan seeks to deliver ambitious and achievable remedies to the ills of some of the most serious causes of short-term thinking in the British economy.

The Action Plan promotes a series of actions to improve long-term investment; importantly, long-termism is not a blind attitude. Asset managers have to act in the best interests of their clients, these best interests may sometimes result in actions which appear to be short term, demanding change from companies or opposing management strategies, but are actually in the long term interests of the end client. Many of the recommendations are designed to improve the flow of information and feedback on the issues that are likely to matter most.

The underlying rationale is clear, stronger businesses and economies deliver the exceptional long-term investment returns that the many millions of people, whose savings and investments are managed by our industry, both demand and deserve.

STEERING COMMITTEE

Nick Anderson, Head of Investment Research, Henderson Global Investors

Richard Buxton, Chief Executive Officer, Old Mutual Global Investors

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ACKNOWLEDGEMENTS

We would like to thank the members of the Steering Committee for their commitment to this project, without their intellectual contribution and industry experience the Investment Association would not have been able to bring together such a wide ranging Action Plan. We would also like to thank all other members who have provided input and suggestions to the Action Plan as it has been developed over the last 6 months. Finally, we would like to thank the team from across the IA led by Andrew Ninian and Phineas Glover who have provided their significant insight and knowledge in the development of the Action Plan.

EXECUTIVE SUMMARY

SINCE 2010, THE UK HAS OUTPERFORMED IN JOB CREATION AND GDP GROWTH. PRODUCTIVITY GROWTH, HOWEVER, REMAINS 16 PERCENT BELOW ITS PRE-2008 TREND RATE. EVEN TAKING INTO ACCOUNT POSSIBLE MEASUREMENT ISSUES AND SECULAR CHANGES, THIS SHORTFALL IS LARGE – AND OFTEN REFERRED TO AS THE 'PRODUCTIVITY PUZZLE'.

In July 2015, the Chancellor published "Fixing the Foundations: Creating a more prosperous nation," a comprehensive plan setting the agenda for the whole of Government over the current Parliament with an aim to reverse the UK's long-term productivity problem. The Investment Association (the IA) welcomed this and committed to developing an Action Plan on how the investment industry can play its part by improving productivity with long-term investment.

Productivity is about how well people combine resources to produce goods and services. It is about creating more from less and, through the process of renewing physical and intangible capital, it provides the essential ingredients of wealth creation and economic prosperity. For productivity to improve, businesses and investors need to be able to invest for the long term. Expanding the productive capacity of a modern economy requires long-term investment in assets such as infrastructure, research and development, factories and equipment and real estate.

An efficient capital market should be configured to transfer savings from today into investment tomorrow and growth the day after – but questions loom about the supply of long-term finance critical for achieving productivity improvements. As a share of GDP, investment in the UK has ranked in the lowest 10 percent for 16 of the last 21 years[1]. In short, capital investment in the UK is too low.

The post-financial crisis agenda quite rightly focused on developing regulation to address the weaknesses exposed to reduce the probability and cost of any future disruption. Crucially, however, there is evidence that the post-crisis system is not well structured to facilitate long-term investment approaches and the provision of growth capital.

All the way from individual savers to the decision making of corporate leaders, there are multiple reasons for this. From the asset allocation of pensions and insurers, to the incentives and governance of the investment strategies deployed, all the way down to the individual portfolio decisions and engagement with corporate leaders: more attention should be paid to the alignment of incentives with the long-term investment needs of the economy.

Addressing these impediments might sound nebulous but is critically important for the functioning of UK economy. More efficient matching between the requirements of savers with the real-economy demands for finance is much more than an investment chain of intermediation. It is the cycle of capital that contributes to confidence, job creation and business investment, all the way from an SME raising money to invest in new machinery to multibillion pound infrastructure projects.

Reflecting the wide-ranging nature of these challenges, the project Steering Committee developed a set of fundamental principles to define an ideal framework for how investors can contribute to productivity improvements with long-term investment. This directed the review's diagnosis of the current system's short-comings and the identification of solutions to address these challenges.

> “IT IS THE CYCLE OF CAPITAL THAT CONTRIBUTES TO CONFIDENCE, JOB CREATION AND BUSINESS INVESTMENT. . . ”

[1] OECD stats database: quarterly National Accounts

INVESTOR PRODUCTIVITY PRINCIPLES

1. **Enhance company reporting for efficient capital allocation:** *through investment and analytical expertise, the investment industry will seek to identify and finance those companies contributing productive growth in the economy.*

2. **Enhance investor stewardship and engagement:** *the investment industry will engage with companies to help them achieve sustainable value creation over the long term and support investments in improved productivity.*

3. **Simplify behavioural incentives and the investment chain:** *the investment industry will work to ensure that the agreed incentives and governance of the investment chain ensure a clear alignment with clients' long-term investment objectives.*

4. **Develop efficient and diverse capital markets:** *as key capital market participants, the investment industry has a key role in the development of asset classes and the efficient functioning of capital markets.*

5. **Overcome tax and regulatory impediments to the provision of long-term finance:** *the investment industry should contribute to the debate on the tax and regulatory impediments to investment so as to ensure the right long-term outcomes for clients.*

In theory, pension funds, insurance companies, and other asset owners all have a natural alignment with the long-term financing needs of the economy. However, the capital models of well-meaning solvency and prudential regulation are inadvertently leading to excessive de-risking in asset allocation and impeding the supply of longer-term forms of capital, such as equity, infrastructure and private placements.

This is leading to an over-emphasis on short-term market risk in prudential regulation. This is, in turn, embedding a focus on volatility and benchmark tracking error in the governance of the investment strategies deployed, rather than the use of informed judgement of longer-term firm-level risks, consistent with the investment horizons of clients.

The relationship between asset owners and asset managers is a critical juncture in determining portfolio strategies. It should be formulated in a way that ensures that asset managers are able to meet their clients' investment needs and focus capital on the long term. These behavioural incentives should drive long term decision making, efficient allocation and embed a stewardship approach.

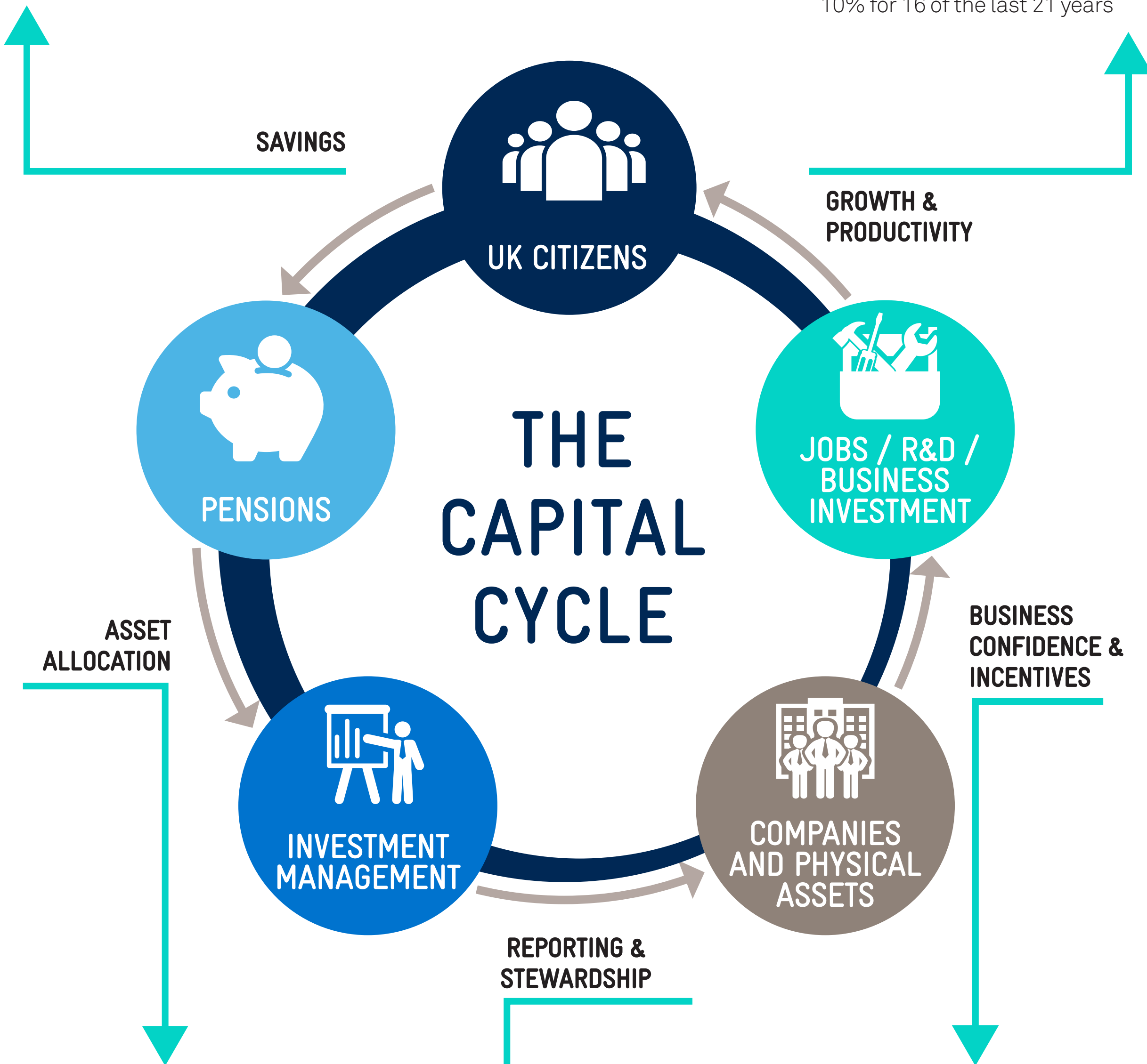
For there to be efficient allocation of capital by asset managers that effectively supports and challenges companies' productivity and capital expenditures, then company reporting, accounting standards and investment research must enable such analysis by asset managers. Equally, supporting long-term investment and productivity requires effective dialogue between investors and companies. By exercising stewardship responsibilities effectively, investors are well placed to ensure companies adopt a long-term approach.

Finally, taking steps to develop efficient and diverse capital markets is a crucial part of ensuring market confidence and protecting our end clients' interests. Here, more can be done to improve the efficiency of the capital raising process for both equity and non-equity capital and to expand the diversity of financing options.

Ensuring a supply of long-term finance adequate to address the needs to improve UK productivity will be a difficult task and the solutions are not simple. This is a challenge that calls for a multifaceted response and a package of measures: no single magic bullet will improve productivity. The Action Plan comprises a package of five overarching objectives and a series of recommendations and tangible actions to deliver these. Each represents a future work programme in its own right.

BARRIERS & IMPEDIMENTS
- Unequal treatment of DB and DC schemes
- Barriers for DC scheme making long-term investments

BARRIERS & IMPEDIMENTS
- Productivity growth remains 16% below its pre-2008 trend rate
- As a share of GDP, investment in the UK has ranked in the lowest 10% for 16 of the last 21 years



BARRIERS & IMPEDIMENTS
- Solvency rules leading to excessive de-risking
- Prudential Sourcebook embedding focus on market risk and tracking error
- Mandates not always aligned with long-term approach and stewardship

BARRIERS & IMPEDIMENTS
- Quarterly reporting short term and lacking focus on productivity
- Need for better reporting and dialogue on capital management
- Need for engagement to focus on long-term value creation and productivity

BARRIERS & IMPEDIMENTS
- Executive remuneration creating perverse incentives and not linked to long term
- Tax debt-bias in funding structures leading to financial stability risks

SUMMARY ACTION PLAN

1 ENHANCE COMPANY REPORTING FOR EFFICIENT CAPITAL ALLOCATION:

Recommendation 1: Improve reporting and research on productivity and re-focus on longer-term strategic drivers

ACTIONS:

- Seek clearer articulation and measurement of the long-term drivers of productivity and work with companies to develop appropriate Key Performance Indicators.
- Issue a Public Position Statement calling for listed companies to cease reporting quarterly and refocus reporting on a broader range of strategic issues.
- Call for the provision of increased Longer-Term and Thematic Investment Research.

Recommendation 2: Improve reporting on capital management and clarify investor expectations of capital management

ACTIONS:

- Work with companies to improve how they articulate their capital management strategy and reporting of outcomes.
- Encourage the FRC's Financial Reporting Lab to undertake a project to develop best practice guidance on the consistent disclosure of a company's cost of capital.
- Develop an investment industry Public Position Statement on how investor engagement can support and challenge company capital management decisions.

Recommendation 3: Improve reporting on culture, human capital and accounting for intangibles

ACTION:

- Raise the profile of Human Capital Management as a material investment consideration and promote better company reporting to facilitate enhanced investor analysis.
- Support the work of the FRC's Culture Project.
- Engage with the IASB to expedite its research on accounting for intangible assets.

2 ENHANCE INVESTOR STEWARDSHIP AND ENGAGEMENT:

Recommendation 4: More formally incorporate a focus on long-term value creation and productivity into engagement practices

ACTIONS:

- Seek wider support and financing for the work of the Investor Forum by launching an independent membership fee.
- Support asset managers in the public reporting of stewardship activities.

3 SIMPLIFY BEHAVIOURAL INCENTIVES AND THE INVESTMENT CHAIN:

Recommendation 5: Ensure that the relationship between asset owners and investment managers is governed in way that does not inadvertently embed a short-term focus

ACTIONS:

- Work with the Pensions Regulator, the PLSA, and investment consultants to develop best-practice guidance on how stewardship and long-term incentives can be better incorporated into the Statement of Investment Principles and Mandate design.
- Investment consultants are encouraged to issue public position statements describing how their activities support the provision of long-term investment approaches and stewardship in mandate design and performance evaluation.

Recommendation 6: Consideration of how greater opportunities for long-term investment can be made available to investors in defined contribution schemes

ACTION:

- Establish a Working Group of key stakeholders to consider the key regulatory and market barriers to creating a DC investment environment more suited to long term investment.

Recommendation 7: Foster improved understanding of the investment horizons of investment managers

ACTION:

- Examine methodologies for calculating average holding periods with a view to developing a standard approach across the industry.

Recommendation 8: Ensure that executive remuneration structures are aligned to long-term decision making

ACTION:

- Consider the findings of the Executive Remuneration Working Group's review of executive remuneration structures and launch an extensive programme of engagement with listed companies.

4 DEVELOP EFFICIENT AND DIVERSE CAPITAL MARKETS:

Recommendation 9: Encourage Equity Investment and Improve the Equity Offering Process

ACTIONS:

- Develop earlier engagement between institutional investors and small and mid-size early stage pre-IPO companies.
- Lower the cost of issuing equity capital and removing the information asymmetry that exists at the expense of investors.
- Engage with the European Commissions on the proposed Prospectus Regulation.
- Engage with key stakeholders to improve and support the efficiency of the secondary market capital raising process whilst maintaining investor protections.

Recommendation 10: Ensure the efficient operation of the markets for other asset classes to ensure the provision of diverse capital markets

ACTIONS:

- Continue to engage with the European Commission on the proposed Prospectus Regulation to promote the key priorities of asset managers for non-equity securities.
- Promote a more efficient new issuance process in fixed income markets and aide secondary market liquidity through the use of clear terminology and standard definitions in covenants for sterling and euro bond issues.
- Promote appropriate behaviours and investor expectations in fixed income markets and support the work of the Financial Markets Standards Board and the FCA Debt Markets Forum.
- Develop and promote guidelines for Housing Associations raising capital in public markets.
- Work with the UK Municipal Agency to promote the development of a UK municipal bond market and highlight the interest of investors in this sector.
- Support on-going work to develop European Private Placements and the revival of the securitisation market in UK and Europe.

5 OVERCOME TAX AND REGULATORY IMPEDIMENTS TO THE PROVISION OF LONG-TERM FINANCE:

Recommendation 11: Ensure that solvency and prudential regulation does not inadvertently impede investment managers from investing in a manner consistent with their clients' long-term interests

ACTIONS:

- Encourage the FCA to undertake a thematic review of whether the approach to market risk in prudential and conduct regulation is resulting in investment decisions that are consistent with the long-term investment objectives of clients.
- Convene a multi-stakeholder Working Group to review the extent to which current accounting standards and solvency and prudential regulatory requirements may be resulting in excessive de-risking by insurers and pension funds and impeding the provision of longer-term forms of finance.

Recommendation 12: Review the causes of "debt-bias" and its effect on financial stability and procyclical decision-making

ACTION:

- Undertake a comprehensive review of why companies favour funding through debt rather than equity.

ROLE OF INVESTORS IN CONTRIBUTING TO PRODUCTIVITY

INTRODUCTION

In July 2015, the Chancellor published "Fixing the Foundations: Creating a more prosperous nation," a comprehensive plan setting the agenda for the whole of Government over the current Parliament with an aim to reverse the UK's long-term productivity problem. The Government's ambitious and wide-ranging framework for raising productivity includes 15 key areas, built around two pillars: first, encouraging long term investment, and secondly, promoting a dynamic economy.

The Investment Association (the IA) welcomed this and, following an exchange of letters between the Chancellor of the Exchequer and a group of eight leading asset managers and the Investor Forum, committed to developing an Action Plan on how the investment industry can play its part by encouraging long-term investment. As major allocators of capital and through our interaction with investee companies, our members are major contributors to UK competitiveness and productivity.

Recognising the importance of the asset management industry as the critical link between savers and the real economy, this report is the result of a six month review of the role of the investment industry in supporting productivity improvements with long-term investment. Intellectual stewardship and guidance was provided by an actively engaged Steering Committee, comprised of the CEOs and senior fund managers of some of the largest investors in the UK economy.

The first step of the Steering Committee was to develop a framework for considering the key components of, and challenges to, long-term investment. This was reflected in the development of five key Investor Productivity Principles which articulate a vision for the appropriate role of the investment industry and directed the scope of the review. This informed the analysis of the Committee and formed the basis for the conclusions and the Action Plan.

The Action Plan comprises a package of five overarching objectives, addressing the challenge from a systemic, macro perspective, in terms of the functioning of regulatory regime and capital markets, and from a micro, bottom-up perspective, in terms of the reporting of companies and the stewardship of investors. Each objective is underpinned by a series of recommendations. To deliver these, a series of tangible actions are proposed and each represents a future work programme in its own right.

It is important that this report does not gather dust, and therefore a clear measurement of the success of each recommendation is also stated, and the progress on delivering the Action Plan will be reviewed every six months. The IA will send a letter to the Chancellor on the first and third anniversaries of publication of the Action Plan to outline progress against the individual recommendations and actions.

“THE IA WILL SEND A LETTER TO THE CHANCELLOR ON THE FIRST AND THIRD ANNIVERSARIES OF PUBLICATION OF THE ACTION PLAN TO OUTLINE PROGRESS AGAINST THE INDIVIDUAL RECOMMENDATIONS AND ACTIONS.”

INVESTOR PRODUCTIVITY PRINCIPLES

There has been a great deal of debate among economists over the causes of the UK's so-called 'productivity puzzle'. It is clear that very wide-ranging and multidimensional factors contribute to economic productivity, and it is not the intention of this review to provide definitive answers to this broader debate. Our chief concern relates to how the investment industry can play its part. It is therefore important to articulate the appropriate role of investors in improving productivity.

By articulating a set of fundamental principles that seek to define an ideal framework for how investors can contribute to productivity improvements with long-term investment, we can diagnose the current system's short-comings and begin to identify solutions that can address these challenges. The following set of Principles were developed by the Steering Committee as a way to examine the appropriate role and responsibilities of asset managers in contributing to productivity and, in turn, to analyse the challenges presented in fulfilling them.

Enhance company reporting for efficient capital allocations: *through investment and analytical expertise, the investment industry will seek to identify and finance those companies contributing productive growth in the economy.*

The design and implementation of an asset manager's investment process, including its analytical capabilities and decision-making, are core features of its business model. The success of these will contribute to investment performance and the delivery of the investment objectives of clients. To deliver client outcomes, among other investment strategies, asset managers will assess the prospects of companies and seek to identify those most able to deliver value to shareholders over the long term. This entails an assessment of the management of, and likely return on, invested capital by companies.

The extent to which a company is able to provide a return on invested capital, whether by managing its cost-base or increasing its sales through business investment, will determine its long-term profitability and success. Therefore, in this context, a company's long-term capital efficiency will determine its productivity. However, for there to be efficient allocation of capital by asset managers that rewards companies for improving productivity and/or those investing to improve capital efficiency, then company reporting, accounting standards and investment research must enable such analysis by asset managers.

> "BY ARTICULATING A SET OF FUNDAMENTAL PRINCIPLES THAT SEEK TO DEFINE AN IDEAL FRAMEWORK FOR HOW INVESTORS CAN CONTRIBUTE TO PRODUCTIVITY IMPROVEMENTS WITH LONG-TERM INVESTMENT, WE CAN DIAGNOSE THE CURRENT SYSTEM'S SHORT-COMINGS AND BEGIN TO IDENTIFY SOLUTIONS THAT CAN ADDRESS THESE CHALLENGES."

Enhance investor stewardship and engagement: *the investment industry will engage with companies to help them achieve sustainable value creation over the long term and support investments in improved productivity.*

While the primary responsibility for promoting the success of a company rests with the Board and its oversight of management, investors play a crucial role in holding the Board to account for the fulfilment of its responsibilities. Shareholder stewardship should aim to promote the long-term success of companies in such a way that the ultimate providers of capital will also prosper. In this sense, there should be a natural alignment of interests: effective stewardship should benefit companies, investors and the economy as a whole.

Supporting long-term investment and productivity requires effective dialogue between investors and companies. By exercising stewardship responsibilities effectively, investors are well placed to ensure companies adopt a long-term approach. For example, through purposeful dialogue, shareholders can demonstrate support for expenditures that will boost productivity and challenge companies compromising it as a result of poor capital management.

To the extent that institutional investors incorporate productivity into their engagement, it is important for investors to support and challenge corporate expenditures so as to ensure sustainable capital management. For example, challenging expenditures which are not appropriately linked to the long term strategic plan, or where companies are reducing equity through unjustified share buybacks.

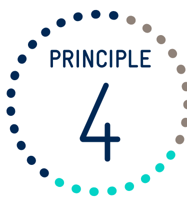
Simplify behavioural incentives and the investment chain: *the investment industry will work to ensure that the agreed incentives and governance of the investment chain ensure a clear alignment with clients' long-term investment objectives.*

The investment chain is a term often used to describe the structure of shareholding of listed companies, reflecting that there is a chain of intermediation from beneficial owners, the 'savers', to the asset managers, the ultimate portfolio decision-maker. In reality, this is more of a capital cycle, and forms the financial architecture by which savings are channelled from households, invested by asset managers, and ensures the supply of finance to meet the growing investment needs of the economy.

Economic theory suggests that interests are aligned throughout this chain, from beneficiaries (the owners of capital), to pension fund trustees, investment consultants, investment managers, and the ultimate recipients of capital, the listed companies. Meanwhile, the company responds to the signals from its owners by managing returns to them over the long term. Hence, an efficient capital market transfers today's savings into tomorrow's investment, and long-term growth should prevail.

The Kay Review[2] provided a comprehensive analysis of the agency problems connected with the investment chain of intermediation, including the direct and indirect impediments to adopting a long-term approach. However there remain a number of areas that require further consideration so as to ensure the relationship between asset owners and asset managers is governed in a way that embeds a long-term investment approach.

[2] J. Kay (2012) The Kay Review of UK Equity Markets and Long-term Decision Making: Final Report. Dept. of Business Innovation and Skills. Available at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf



Develop efficient and diverse capital markets: *as key capital market participants, the investment industry has a key role in the development of asset classes and the efficient functioning of capital markets.*

To catalyse UK productivity growth, companies must be able to access the finance they need to invest in new technology and growth. This requires an investment environment that supports efficient and diverse capital, and protects the interests of investors. Therefore, our collective influence as shareholders needs to be complemented by policy measures to enable capital markets to function more efficiently.

As perpetual capital, equity investment provides the best "slow money" for long-term productive growth. There is also more that can be done to improve the flow of institutional funds into other asset classes issued by both large and smaller companies. A broad spectrum of financial instruments and other asset classes should be available to support long-term investment. Subject to clients' risk and reward requirements, the asset management industry is well positioned to help develop other capital markets in the UK such as private placements, municipal bonds, local authority debt markets and securitisations.

Overcome tax and regulatory impediments to support the provision of long-term finance: *the investment industry should contribute to the debate on the tax and regulatory impediments to investment so as to ensure the right long-term outcomes for clients.*

While investors have different mandates, investment strategies, incentives and knowledge of the markets in which they are investing, regulatory and tax developments remain an important factor in shaping the asset allocation strategies of institutional investors. Both have important implications for long-term investment and financial stability.

On the supply side, the tax system continues to incentivise businesses to use debt rather than equity finance, and the extent to which this "debt-bias" might contribute to pro-cyclicality and financial instability is increasingly a focus of regulators. On the demand side, there is a concern that solvency regulation is inadvertently impeding long-term asset allocation strategies. The extent to which both might be linked to pro-cyclical investment outcomes and financial stability, is a matter of continued review by the Bank of England.

ONE OF THE GOALS OF THE FINANCIAL SYSTEM IS TO EFFICIENTLY TRANSFER SAVINGS FROM TODAY INTO INVESTMENT TOMORROW AND GROWTH THE DAY AFTER. IN REALITY, HOWEVER, LONG-TERM FINANCING IS NOT ALWAYS EXECUTED WITH TERMS AND VEHICLES THAT ARE APPROPRIATELY TAILORED TO THE LONG-TERM INVESTMENT OBJECTIVES OF THE ULTIMATE SAVERS. THE FOLLOWING ACTION PLAN ANALYSES HOW EACH STAGE IN THIS FRAMEWORK CURRENTLY FUNCTIONS, IDENTIFIES AREAS IN WHICH THE SYSTEM FALLS SHORT OF THE PRINCIPLES DESCRIBED ABOVE, AND PROPOSES A SERIES OF RECOMMENDATIONS AND ACTIONS TO ADDRESS THEM.

ACTION PLAN

1 ENHANCE COMPANY REPORTING FOR EFFICIENT CAPITAL ALLOCATION

SUPPORTING PRINCIPLE

THROUGH INVESTMENT AND ANALYTICAL EXPERTISE, THE INVESTMENT INDUSTRY WILL SEEK TO IDENTIFY AND FINANCE THOSE COMPANIES CONTRIBUTING PRODUCTIVE GROWTH IN THE ECONOMY.

INTRODUCTION

Annual reports are an important source of information for investors. They should provide a real understanding of a business and its drivers, its financial strength, and the quality of management and their decisions. Investors look to the annual report to provide the building blocks on which they make investment decisions. The quality of these reports really matters for the efficient allocation of capital.

The analysis of the annual report is a fundamental part of investors' research process. However, they have significant concerns over how companies are reporting on their long-term strategy and capital management. While investors set out to assess a company's likely return on invested capital, and understand how the overall balance of expenditures[3] will support productivity over the long term, senior portfolio managers reported that this is very difficult in practice.

Reforms to corporate reporting following the financial crisis rightly focused on making narrative reporting simpler, clearer and more focussed, with a particular emphasis on a company's strategy and business model. In 2013 the Department for Business Innovation and Skills issued new regulations for narrative reporting, which amended existing company law[4] and in 2014 the Financial Reporting Council (FRC) issued Guidance on the Strategic Report. However, there has been little focus on improving reporting on capital management.

The Steering Committee referred to a number of areas of company reporting that significantly impede the ability of investors to understand, and support, a company's long-term strategy and capital investments. Examples of these include:

- A lack of clarity on companies' management of capital: shareholders are often unable to assess accurately the capital position of companies, thus hindering their ability to assess the effectiveness of capital allocation strategies.
- Furthermore, the measurement of return on invested capital is difficult given company disclosures.
- No articulation of overall capital management policy and practice: portfolio managers frequently commented that there is lack of meaningful information concerning future expenditure plans, how these will improve the business and how they are linked to strategy.
- Accounting standards[5]: acquired and internally generated intangible assets are disclosed together, obscuring the economics of acquisitions and other business costs. Concerns were also raised over the treatment of research and development costs.
- Quarterly reporting was widely referred to as a distraction that shifted company resources away from longer-term strategic considerations.

[3] For example, capital expenditure, operational expenditure, research & development, dividends and buy-backs

[4] The Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013

[5] For example, IFRS 3, Business Combinations and IAS 38, Intangible Assets

REPORTING ON LONG-TERM DRIVERS OF VALUE CREATION

There has been evidence in recent years of improvements in reporting; one of the benefits of the requirement for directors to consider whether the annual report as a whole is 'fair, balanced and understandable'. However, disclosures of a company's strategy and business model are still falling short of investor expectations. A recent review of 100 annual report and accounts found that 42% do not explain how the company makes money and only 9% make a clear link between strategy, KPIs, principal risks and remuneration[6].

The drivers to improve productivity will inevitably be different for different companies and the sectors they occupy, and it takes time before any investment can improve productivity and yields results. This is as true as it is for investment in human capital at an education company, as it is for major capital expenditure at a global mining company.

However, the reality of investment decisions dictate that the longer the time span before cash returns are expected to be achieved the more they will be discounted by the market. This is why high quality reporting on long-term strategic issues is of such importance for shareholder understanding of the business. This is supported by evidence that capital markets support well-articulated expenditures on R&D[7].

Moreover, quarterly reporting can distort management behaviour by channelling its focus on short-term fluctuations in performance, resulting in the risk of senior management increasingly focusing on managing the market rather than the business. In this respect, there is evidence that management will delay investment in R&D and capex if they believe it will stop them achieving short term performance targets and meeting market guidance[8].

The practice of quarterly reporting[9] and the issuance of short-term earnings guidance are increasingly viewed as a distraction, and members of the Steering Committee were clear that they would like to see companies move away from such short-term reporting and guidance in favour of long-term metrics. Investors would like to see improvements in reporting on the long-term drivers of sustainable value creation and for companies to shift their resources towards improved reporting on long-term strategy and capital management.

RECOMMENDATION 1:

IMPROVE REPORTING AND RESEARCH ON PRODUCTIVITY AND RE-FOCUS ON LONGER-TERM STRATEGIC DRIVERS

ACTIONS:

Seek clearer articulation and measurement of the long-term drivers of productivity and work with companies to develop appropriate Key Performance Indicators.

With input from the Productivity Leadership Group, led by Sir Charlie Mayfield, the IA will develop proposals for the articulation and measurement of the long-term drivers of productivity and Key Performance Indicators (KPIs). These KPIs will form part of a broader document, Long-Term Reporting Guidance, which will encompass all Actions under recommendations 1, 2 and 3 - including reporting on productivity, human capital, culture, long-term strategy and capital management and outcomes – and will set-out investors' views on how to re-focus reporting on the longer-term strategic drivers of performance.

6 EY (Sept 2015) Annual reporting 2014: reflections on the past, direction for the future. Available at: http://www.ey.com/UK/en/Issues/Governance-and-reporting/Corporate-governance/EY-Annual-reporting-in-2014

7 Deutsche Bank Research (June 2011) Capital market reward R&D. E-conomics, Issue 83. Available at www.dbresearch.com

8 J. R. Graham, C. R. Harvey, and S. Rajgopal (2005) The Economic Implications of Corporate Financial Reporting. Journal of Accounting and Economics. v40 (1-3) pp.3-73.

9 In the UK, it was previously a requirement under the EU Transparency Directive and the FCA Handbook to issue Interim Management Statements, which in common parlance are referred to as "quarterly reporting".

Issue a Public Position Statement calling for listed companies to cease reporting quarterly and refocus reporting on a broader range of strategic issues.

Following the Kay Review, the UK Government supported the European Commission proposal to amend the Transparency Directive to remove mandatory quarterly reporting requirements. The amending Directive came into force in November 2013. It was enacted into UK law in May 2014 and the FCA updated the Disclosure and Transparency rules in December 2014. Nevertheless, the majority of UK listed companies continue to report quarterly voluntarily.

The IA will publish a position statement calling for companies to cease quarterly reporting and guidance in favour of focussing reporting on longer-term performance and strategic issues. Any companies that continue to report quarterly will be asked to explain why they do so and how it is relevant to their long-term strategy. The IA will hold a number of roundtable discussions with companies, company representatives and investors to discuss the benefits and challenges of the abolition of quarterly reporting. Based on the feedback received the IA will publish a guidance document.

Call for the provision of increased Longer-Term and Thematic Investment Research.

To support long-term investment decisions by asset managers there is a need for the provision of longer-term research. This research can either be produced internally by the asset manager or may be procured from an investment bank or independent research provider. The exact needs of investment managers will depend on the individual firm and its investment strategy. To the extent that it is provided by investment banks or other research providers there is a general need for these research providers to cater for this growing demand for longer-term thematic research rather than the typical focus on short-term results-based analysis. While there are existing initiatives in place to articulate the investment manager demand for more long-term research, our members will continue to communicate their requirements to investment banks and other research providers. In the Long-Term Reporting Guidance we will set out high-level guidance on investor expectations of long-term research.

REVIEW:

- Six and eighteen months following the publication of the Quarterly Reporting Position Statement, the IA will undertake a review of how many companies continue to report on a quarterly basis. Companies that continue to do so will be identified by the IA's corporate governance research service, IVIS. The IVIS report for those companies will note that the company continues to report on a quarterly basis and any explanation provided will be included in the IVIS report.

- The IA will undertake an analysis of the 2017 annual report and accounts to review the extent to which the productivity KPIs have been disclosed and, more broadly, the quality of reporting under the Long-Term Reporting Guidance. The findings of this review will establish the IA's position regarding BIS's post-implementation review of the success of the new strategic report regulations. The IA's IVIS will review company disclosures to see if companies are adopting the new reporting guidance and will outline in its reports to shareholders the company's approach to investors.

- In 2018, the IA will review the provision of Long-Term and Thematic Research by investment banks and other research providers.

CASE STUDY
QUARTERLY REPORTING

On 26th November 2010, Unilever Plc announced that it would change the way it reports its results. Unilever would release a quarterly trading statement for quarters 1 and 3 instead of publishing full financial results.

In the announcement to the market the company stated:

"Unilever is making this change to provide a better understanding of the top-line performance of the business, its categories and brands on a quarterly basis, whilst ensuring that the discussion of the full financial results is focused on a more meaningful time period of six months. The intention is to enhance communication of performance and to move from a short to a longer term focus better reflecting the way Unilever manages the business."

"UNILEVER CONSULTED SHAREHOLDERS PRIOR TO ABANDONING FULL QUARTERLY REPORTING. THE CHAIRMAN TOLD ME LATER THAT THERE WERE MIXED VIEWS AMONGST INVESTORS AND ON THE BOARD – BUT WITHIN A YEAR OF MAKING THE CHANGE, THE BOARD WAS UNANIMOUS THAT IT WAS A GOOD DECISION, ENCOURAGING A FOCUS ON THE LONG-TERM NOT RUNNING THE BUSINESS FOR 90 DAY HORIZONS."

Richard Buxton,
Chief Executive,
Old Mutual Global Investors

"AS A MAJOR INVESTOR OF SHARES AND BONDS OF UK LISTED COMPANIES, INVESTED THROUGH BOTH ACTIVE AND INDEX FUNDS, WE HIGHLY VALUE THE COMMUNICATION WE HAVE WITH MANAGEMENT TEAMS. FOR MANY BUSINESSES, WE BELIEVE, REDUCING THE TIME SPENT ON FREQUENT REPORTING COULD HELP MANAGEMENT TO FOCUS MORE ON LONG TERM STRATEGIES AND ARTICULATE MORE ON MARKET DYNAMICS AND INNOVATION DRIVERS THAT WILL ENHANCE THEIR PERFORMANCE OVER TIME."

Mark Zinkula,
Chief Executive,
Legal & General Investment Management

CORPORATE EXPENDITURES AND CAPITAL MANAGEMENT

To support the expenditures and investments that will contribute to productivity improvements, shareholders need to be able to assess a company's capital position, management and expenditures. Reporting of this underpins investor confidence and facilitates the dialogue between shareholders and companies, and should help investors understand how expenditures are consistent with the company's strategy and could enhance productivity.

Specifically in relation to reporting on capital management and expenditures, a review undertaken by the Financial Reporting Council (FRC)[10] in 2010 found that only 20 percent of the companies reviewed provided 'informative' reporting on their financial capital resources and how it related to their strategy for growth, M&A, share buy backs and/or dividends. The majority omitted or provided largely boilerplate information that failed to convey meaningfully how they assess capital and manage it over the medium to long term. In relation to International Financial Reporting Standards (IFRS) disclosure requirements[11], only 10 percent of the companies reviewed provided 'fairly informative' information, with 76 percent providing disclosures rated as either 'boilerplate' or 'missing'.

More recently, in November 2015, the FRC's Financial Reporting Lab published a report[12] on the disclosure of dividends, with the aim of outlining an approach to good disclosures of dividend policy and practices under those policies. Given this is an important aspect of a company's cash and capital management, we await to see how companies will report against this useful framework.

The reciprocity for improved reporting by companies and dialogue on productivity and capital expenditure is for investors to be clear regarding their expectations of capital management. It is imperative that companies do not unwittingly delay or cease commercially viable investments as a result of a misconception arising from a poorly organised dialogue between a company and its investors.

Members of the Steering Committee noted that companies often misunderstood investors' expected return on invested capital. This was causing unnecessary caution by management: "If in doubt, return the cash"; whereas shareholders are often very willing to support well-reasoned and articulated capital and operational expenditures which are consistent with a company's strategy and which will support long-term productivity improvements.

RECOMMENDATION 2:

IMPROVE REPORTING ON CAPITAL MANAGEMENT AND CLARIFY INVESTOR EXPECTATIONS OF CAPITAL MANAGEMENT

ACTIONS:

Improve how companies articulate their capital management strategy and reporting of outcomes.

Under the Long-Term Reporting Guidance (outlined under recommendation 1) the IA will seek to develop improved disclosures of corporate expenditures and capital management policy, strategy and outcomes. Specifically, this will seek improved disclosure of:

- the objectives, policies and processes for managing capital (IFRS International Accounting Standard 1.135), including the Board's oversight of final investment decisions
- the outcomes of capital management and dialogue with shareholders; including a narrative discussion of the important decisions made during the year, how expenditures support the long-term strategy and the engagement with shareholders on this during the year, and
- consistent annual disclosure of working capital, investment capex, R&D, capital management (debt servicing, dividends and buybacks), variable pay to insiders and investment in people.

[10] Accounting Standards Board (2010) *Financial Capital and Management Disclosures*

[11] IAS 1.134 requires a company to disclose information that enables users of its financial statements to evaluate the entity's objectives, policies and processes for managing capital.

IAS 1.135 explains that this objective is met by disclosing qualitative and quantitative data. The former should include narrative information such as what the company manages as capital, whether there are any external capital requirements and how those requirements are incorporated into the management of capital.

[12] FRC Financial Reporting Lab (2015) Disclosure of dividends – policy and practice

Encourage the FRC's Financial Reporting Lab to undertake a project to develop best practice guidance on the consistent disclosure of a company's cost of capital.

It is important that the above disclosures are understood in the context of a company's cost of capital. This underpins the overall decision-making process of the company and the rationale for the expenditures that shareholders will seek to support or challenge. The IA believes that companies should disclose their cost of capital. However, recognising that there are different approaches to how companies calculate their cost of capital and that practices vary across different sectors, the IA recommends that the FRC's Financial Reporting Lab undertakes a project, drawing on the views of companies and investors, to develop best practice guidance to ensure consistent cost of capital disclosures.

Develop an investment industry Public Position Statement on how investor engagement can support and challenge company capital management decisions.

The Public Position Statement will be published in September 2016. Investors will be encouraged to explain their policies and expectations concerning companies' capital management under their Stewardship Code Statements. Engagement on capital management issues should also form part of the investment manager's disclosure on their stewardship activities (see recommendation 3).

REVIEW:

- The IA will undertake an analysis of companies' 2017 annual report and accounts to review the quality of reporting on capital management policy, strategy and outcomes and, more broadly, the quality of reporting under the Long-Term Reporting Guidance. We will publish a review of our findings. The IA's Institutional Voting Information Service (IVIS)[13] will review company disclosures to see if companies are adopting the new reporting guidance and will outline the company's approach to investors.
- In 2017, the IA will highlight examples of investors incorporating factors relating to corporate capital management into their Stewardship statements.

[13] www.IVIS.co.uk

CASE STUDY
LONG-TERM REPORTING BY WHITBREAD PLC

Since 2011, Whitbread have set key five-year strategic growth milestones to be achieved in its two leading brands Costa and Premier Inn, in the 2014/15 Annual Report they outlined these as:

- In April 2011 they announced their 2016 milestones to reach around 65,000 UK Premier Inn rooms and to double Costa's global system sales to around £1.3 billion.
- In April 2013 they announced their 2018 milestones to reach around 75,000 UK Premier Inn rooms and to double Costa's global system sales to around £2 billion.
- In April 2015 they announced their 2020 milestones to reach around 85,000 UK Premier Inn rooms and to grow Costa's global system sales to around £2.5 billion.

The Chief Executive's statement sets out the sustained investment in their people, brands and infrastructure needed.

Investing in people: *"As we pursue our new 2020 growth milestones we will create around another 15,000 jobs in the UK and we are targeting a significant proportion of these jobs to go to people who are not in education, employment or training. We are investing in skills and development programmes including our WISE programme (Whitbread Investing in Skills and Employment) which goes from strength to strength. In April 2015 we set new ambitious targets to deliver 7,500 employment placements, 6,500 work experience placements and 6,000 apprentices by 2020."*

Investing in customer experience: *"Key to building a strong customer heartbeat is our relentless focus on product improvement and we invest millions of pounds every year in refurbishing and re–imaging our hotels, coffee shops and restaurants as well as strengthening our digital and technological capabilities. As customers' expectations and tastes become increasingly sophisticated, innovation is vital for us to stay ahead of the competition."*

Expenditures for long-term growth: *"In 2015/16 we are increasing our planned capital expenditure to around £700 million as we open more hotel rooms, invest in our freehold pipeline (particularly in London) and deliver our refurbishment and maintenance programmes. With around 5,500 Premier Inn rooms and 250 Costa stores planned to open in 2015/16, this fast–paced growth puts us well on track to achieve our 2016 and 2018 milestones..... The combination of disciplined organic network growth to achieve our 2020 milestones and a good return on capital will create substantial shareholder value."*

"WE SUPPORT COMPANIES HAVING AN APPROACH TO CAPITAL THAT TAKES INTO ACCOUNT RETURNS OF VALUE TO SHAREHOLDERS, A SUSTAINABLE BALANCE SHEET, AND INVESTMENT BASED ON A WELL EVIDENCED BUSINESS CASE."

Jessica Ground,
Global Head of Stewardship,
Schroders plc

"DISCLOSURE OF CORPORATE INVESTMENT IN BOTH PHYSICAL AND HUMAN CAPITAL IS IMPORTANT FOR ANALYSING BUSINESSES. WHITBREAD PLC SETS A GOOD EXAMPLE OF DISCLOSURE IN EACH AREA. THE COMPANY GIVES A CLEAR BREAKDOWN OF ITS SPENDING ON EXPANSION OF ITS PREMIER INN HOTELS, RESTAURANTS AND COSTA COFFEE SHOPS AND ITS SPENDING ON IMPROVEMENT AND MAINTENANCE OF EACH DIVISION, AS WELL AS LINKING THIS TO THE COMPANY'S RETURN ON CAPITAL OVER TIME. IN ADDITION, THE COMPANY REPORTS ON EMPLOYEE RECRUITMENT, EMPLOYEE TRAINING INITIATIVES AND ITS APPRENTICESHIP PROGRAMME, WITH CLEAR TARGETS IN EACH AREA AND A CLEAR LINK TO PRINCIPAL BUSINESS RISKS AND GROUP KPIS."

Simon Gergel,
Chief Investment Officer UK Equities,
Allianz Global Investors

HUMAN CAPITAL, CULTURE AND OTHER INTANGIBLES

A key driver of improving corporate productivity is a company's workforce and whether the workforce is deployed efficiently, including the development of skills and competencies. A recent report from the UK Commission for Employment and Skills[14] shows that in 2015 there will be 209,000 "skills shortage vacancies", those vacancies which are vacant because the employers cannot find people with the skills or knowledge to fill them. This number has risen by 130% since 2011.

In addition, the survey found that two million workers in the UK are under-utilised – in that they have skills and experience which are not being used in their current job. At the same time, UK-listed companies continue to have global operations and have a range of options as to where to locate their workforce. This global mobility has an impact on productivity in the UK. Equally, in a global context for larger multinational companies, the cost of employing staff in the UK compared to other countries has a material influence on productivity.

There is mounting research linking improvements in human capital management with improvements in company performance and productivity[15]. However, company reporting on human capital and other intangibles is nascent. In turn, consideration of this by the investment industry is low. In the last year, there has therefore been a growing focus on human capital reporting.

Investors are increasingly of the view that they should incorporate how well a company manages its workforce into their investment decision-making process. However, for investors to do so, they need companies to improve their reporting. This should enable investors to understand the approach taken and, more directly, how a company's human capital management has impacted its productivity and long-term prospects.

Therefore, an important factor for improving company productivity is neither being reported on by companies nor sufficiently integrated into analysis by investors. This is problematic, as it means a material contributor to company productivity is not being recognised in the investment process. This is despite investors being prepared to apply a market premium to those companies that successfully demonstrate improvements or make appropriate long-term investments in human capital.

The lack of focus on this issue is also in contrast to the increasing significance of human and intellectual capital to the functioning of the economy and the increase in intangible assets on companies' balance sheets. Research by NESTA[16] estimates that between 1990 and 2011, the value of intangible assets in the UK grew from £50.2 billion to £137.5 billion, while at the same time the value of tangible, physical assets has increased much more slowly from £72.1 billion to £89.8 billion (Figure 1). Other research predicts that intangible investment will soon be 50 percent higher than investment in tangibles[17].

Research by the OECD[18] points to growing investment in knowledge-based capital over the long term when compared with other traditional forms of capital. In the UK, investment in knowledge-based capital grew throughout the 1990s, before dipping in the 2000s, while investment in tangible assets fell sharply over the period. By 2009, investment in knowledge-based capital was 34 percent higher than tangible investments.

This also reflects the shift from long term infrastructure companies to more short term technological companies with more intangibles. Research cited by EY in 2010 found that in 2009 the net assets of S&P 500 companies represented only 19% of their market capitalisation compared to 90% in the 1970s[19]. Intangible factors, including the long-term viability of the business, model have become drivers of value and are not necessarily captured by accounting requirements.

14 UKCES (2016) *Employer Skills Survey 2015: UK results.*

15 A. Edmans (2011) *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices.* Journal of Financial Economics. Elsevier Vol. 101 pp. 621-640.

16 Nesta (2015) UK Investment in Intangible Assets: Report for Nesta. Nesta Working Paper No. 12/02

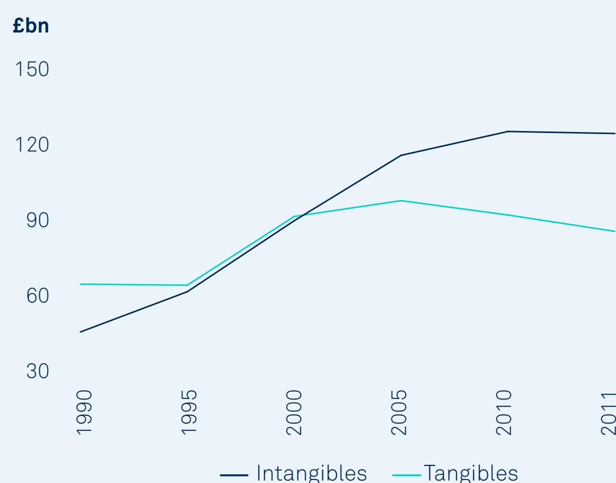
17 W. Hutton (2014) *As Investment Becomes Ever More Intangible, Business Has To Navigate Some Choppy Waters to Survive.* Work. Winter: p11.

18 OECD (2013) *Supporting investment in knowledge capital, growth and innovation.* OECD Publishing.

19 EY (2014) *Integrated Reporting: tips for organizations elevating value.*

Significant concerns were raised by members of the Steering Committee about the accounting for intangibles: both those acquired in a business combination and those that are internally generated. On a business combination some investors will distinguish between what they consider to be "wasting" intangibles that are separately identifiable and have finite useful lives and those that are "organically replaced" and replenished on an ongoing basis. On the other hand for intangible assets that are internally generated, some investors only capitalise development and not research costs[20].

FIGURE 1: UK MARKET SECTOR INVESTMENT IN TANGIBLE AND INTANGIBLE ASSETS, NOMINAL £BNS



Source: Nesta Innovation Index 2014

The role of culture in creating long-term value for a company and its shareholders is increasingly being recognised. There is strong evidence that where employees feel that their company has integrity, companies see an increase in productivity and profitability of the company[21]. Conversely, there are numerous examples where the wrong culture has led to companies putting the short term interests first and jeopardising the long-term prospects of the company.

Therefore, a robust culture needs to be set at the top of the firm but must also pervade the organisation in order to ensure that the whole organisation is working efficiently towards consistent aims. As shareholders, we are seeking to support the companies who foster the right long-term culture as this is key to the delivery of long-term value.

RECOMMENDATION 3:

IMPROVE REPORTING ON CULTURE, HUMAN CAPITAL AND ACCOUNTING FOR INTANGIBLES

ACTIONS:

Raise the profile of Human Capital Management as a material investment consideration and promote better company reporting to facilitate enhanced investor analysis.

The IA has a Working Group of members who have identified the need to improve human capital reporting. The IA hosted an event in November 2015, to promote human capital as a consideration in investment decision making and to highlight the need for improved disclosure on material human capital issues by companies. The IA will work with other stakeholders to outline the approach to company reporting which would be most beneficial to investors. The IA will continue to work with the investment industry and research providers to ensure that human capital management is appropriately incorporated in research analysis and investment decisions.

[20] FRC (2014) FRC ARC Staff Research Report: Investor Views on Intangible Assets and their Amortisation. Available here: https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Research-Report-Investor-Views-on-Intangible-Asset.pdf

[21] L. Guiso, P. Sapienza, and L. Zingales (2015) *The Value of Corporate Culture. Journal of Financial Economics, Elsevier, vol. 117 (1), pp. 60-67*

Support the work of the FRC's Culture Project.

In September 2015, the FRC launched a market-led initiative to gather insights on corporate culture to understand better how boards can shape, embed and assess culture to identify and promote good practice.

The FRC are expected to publish a report on their observations and activity in Summer 2016. We intend to support the work of this project and promote the examples of good practice and resources which will allow the boards of our investee companies to take action on culture.

Engage with the IASB to expedite its research on accounting for intangible assets.

In its response to the IASB's recent Request for Views on its 2015 Agenda, the IA commented that the IASB's approach to research on intangibles, and their impairment and amortisation was fragmented. It encouraged it to undertake a comprehensive research project to look at the inconsistencies between the treatments of acquired and internally generated intangibles, their recognition and measurement, and the accounting for research and development costs. The IA will continue to engage with the IASB on the development of this important project.

REVIEW:

- Human capital reporting requirements of investors will be incorporated into the Long Term Reporting Guidance. In addition, as part of the review of companies' 2017 Annual Reports, the IA will undertake analysis of quality of reporting on material human capital matters. IVIS will also highlight in its reports how companies are reporting on human capital management.

> "THE IA WILL WORK WITH OTHER STAKEHOLDERS TO OUTLINE THE APPROACH TO COMPANY REPORTING WHICH WOULD BE MOST BENEFICIAL TO INVESTORS."

2 ENHANCE INVESTOR STEWARDSHIP AND ENGAGEMENT

SUPPORTING PRINCIPLE

THE INVESTMENT INDUSTRY WILL ENGAGE WITH COMPANIES TO HELP THEM ACHIEVE SUSTAINABLE VALUE CREATION OVER THE LONG TERM AND SUPPORT INVESTMENTS IN IMPROVED PRODUCTIVITY.

INTRODUCTION

The UK is regarded as a world leader in the development of corporate governance and shareholder stewardship. As early as 1990, even before the Cadbury Report came into effect, the Association of British Insurers (ABI) published best practice guidance on both the duties of Directors and the responsibilities of institutional shareholders. Both were forerunners to the current UK Corporate Governance and Stewardship Codes. However, episodes of severe market distress and crisis have periodically challenged popular notions of best practice.

The most recent period of review and reform started following the banking crisis when, in 2009, Sir David Walker undertook his review of corporate governance in UK banks. The principal focus of this Review was on banks, but many of the issues arising, and associated conclusions and recommendations, were considered seminal for the functioning of corporate governance practices more broadly. In considering the role of institutional investors in the banking crisis, he highlighted a number of areas which had impeded the scale of shareholder engagement.

Walker's main conclusion regarding shareholder engagement was that The Code on the Responsibilities of Institutional Investors, prepared by the Institutional Shareholders' Committee, should be ratified by the FRC and become the Stewardship Code. In combination with regular review of the Code by the FRC and monitoring of adherence, it was envisaged that this should drive forward an increase in shareholder engagement.

THE FRC'S STEWARDSHIP CODE

Under the FRC's Stewardship Code, firms authorised to manage funds in the UK are required by the Financial Conduct Authority to "comply or explain" with the Principles of the Code. In the updated Code of 2012, the FRC describes stewardship in the following way:

"Stewardship activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings."

Over the last five years the IA has monitored adherence to the Code. Since 2010 there has been a significant increase in the number of signatories to the Code and there is evidence of improvements in practices. Notably, there is clear evidence of an increase in resources being dedicated to stewardship at asset management firms and more integration between the investment decision-makers and governance specialists.

However, the most recent report[22] found that asset managers were being required to spend most engagement time on executive remuneration at the expense of a focus on wider fundamental factors. This contrasted with the issues that respondents considered the most important, and to which they would have preferred to be engaging with companies on, which in descending order were: corporate performance; board leadership; culture and strategy; board and committee composition; and remuneration.

[22] The Investment Association (2015) Adherence to the FRC's Stewardship Code

For the stewardship activities of institutional investors to have a meaningful influence on companies' long-term productivity and competitiveness, there must be a critical mass of engaged shareholders. Shareholders must also focus their engagement on the long-term drivers of value creation that will ultimately improve productivity.

While the Steering Committee agreed that there had been improvements in practices since the inception of the Code, there were doubts over whether there had been a meaningful uptake in engagement practices across the market more broadly. Most fundamental of all, there was also a concern over a lack of focus on corporate performance and strategy.

While the FRC issued changes to the Code in 2012 seeking to clarify the nature of stewardship, as the Kay Review had recommended, it is still felt that the Code could be strengthened to promote long-term value creation through shareholder engagement. Although there is reference to promoting the long-term success of companies in the preamble to the Code, it was noted that the principles do not make a sufficiently explicit connection between shareholder engagement and promoting medium- to long-term value and capital efficiency.

THE KAY REVIEW AND THE INVESTOR FORUM

While the Walker Review focused on overcoming impediments to the quantity of engagement, in July 2012, the Kay Review highlighted major structural impediments to the effectiveness of engagement.

A principal observation was that the traditional leaders in stewardship and engagement in the UK had dramatically reduced their holdings in UK equities. This had materially weakened the influence of engaged owners on UK corporates. At the time he had found that pension funds and insurance companies had gone from owning 31 per cent and 21 per cent respectively in 1991 to 5 per cent and 9 per cent in 2010.

Interestingly, the most recent data[23] shows that this trend has continued, with pension funds and insurers now owning as little 3 per cent and 5 per cent respectively of UK equities. The drivers of this change are also relevant and are discussed in Section 5 of the Action Plan.

[23] ONS (2015) *Ownership of UK Quoted Shares: 2014*. Statistical Bulletin, 2 September.

FIGURE 2. IMPEDIMENTS TO EFFECTIVE ENGAGEMENT

- Increased international ownership
- Increasingly fragmented shareholdings
- Perception of regulatory barriers to collective engagement
- Lack of integration between investment decision makers and corporate governance specialists
- A disproportionate focus on AGM-related governance matters, leading to a vacuum in respect of companies' strategies for long-term, sustainable value creation.

Kay concluded that there was a need for a radical shift in culture and approach to stewardship:

"Our approach [to stewardship], which emphasises relationships based on trust and respect, is rooted in analysis and engagement, develops and extends the existing concept of stewardship in equity investment. This extended concept of stewardship requires that the skills and knowledge of the asset manager be integrated with the supervisory role of those employed in corporate governance: it looks forward to an engagement which is most commonly positive and supportive, and not merely critical."

Kay Review: principal recommendations in relation to shareholder engagement:

- The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance.
- An Investor Forum should be established to facilitate collective engagement by all investors in UK companies.
- Companies should consult their major long-term investors over major board appointments.

In October 2014, the Investor Forum was constituted as an independent company with a Board of Directors to represent the interests of the entire investment chain – asset owners, asset managers and company representatives – both international and domestic.

Following a period of consultation with the investment industry and other key stakeholders, the Investor Forum published a discussion paper to introduce its approach[24]. The Forum's stated purpose is to put stewardship right at the heart of investment decision-making and its objectives and operating model were configured purposely to address the impediments to engagement raised in the Kay Review.

This includes developing a comprehensive engagement toolkit to facilitate engagement with a focus on long-term value creation and productivity. For example:

- **Collective Engagements:** institutional investors have the opportunity to initiate and be actively involved in collective engagements with all UK-listed companies. This would mark an escalation of individual engagements, when co-ordinated action is required to address situations where long-term value is at risk.
- **Sentiment Surveys:** a confidential survey to equip companies with a summary of the key shareholder views and issues, to be addressed. The survey is a natural indicator of potential collective engagements or Stewardship and Strategy Forums. These surveys to assess market sentiment on a wide range of issues, from strategy, performance and capital management to Board leadership, succession and culture.
- **Stewardship & Strategy Forums:** a new type of regular forum between shareholders and boards designed to combine the stewardship and strategy agendas into one conversation. These events focus on the attributes that make a company competitive and sustainable over the long-term. The Investor Forum will consult on formulating the agenda and provide impartial feedback to the company. By working together proactively these events intend to pre-empt issues which might result in value destruction, and create alternatives to public confrontation at an AGM.
- **Stewardship 360 Programme:** an event programme tailored to address emerging stewardship issues for investors and companies. Open dialogues will be convened with the investor and broader stakeholder communities, which will inform publications which aim to be topical, practical and relevant.

“WE HAVE BEEN ENCOURAGED BY THE FORUM'S ENGAGEMENTS DURING 2015. THESE HAVE DEMONSTRATED THE VALUE OF FOCUSING COMPANY DIALOGUE ON THE LONG-TERM STRATEGIC DRIVERS OF PERFORMANCE, AND ARE AS EQUALLY RELEVANT FOR PORTFOLIO MANAGERS AS FOR CORPORATE GOVERNANCE SPECIALISTS. THE FORUM'S WORK IS BECOMING INCREASINGLY IMPORTANT IN THE CONTEXT OF THE FRAGMENTATION OF EQUITY OWNERSHIP AND THE RELATED CHALLENGE OF BUILDING A COHERENT ENGAGEMENT FOCUS THAT CANNOT BE DISMISSED BY COMPANIES AS A LONE VOICE. THE RECENT ANNOUNCEMENT THAT A THREE YEAR FUNDING COMMITMENT FROM LEADING INVESTORS HAS BEEN SECURED REPRESENTS AN IMPORTANT MILESTONE FOR THE STEWARDSHIP OF UK CAPITAL MARKETS, AND BLACKROCK WAS PLEASED TO BE ONE OF THE FOUNDING FIRMS.”

James Macpherson,
Co-Head of UK Equities,
BlackRock

[24] http://www.investorforum.org.uk/#!history/c22bc

As of February 2016, the Investor Forum had undertaken nine major collective engagements with different companies, focusing on the following range of topics.

FIGURE 3. INVESTOR FORUM 2015 ENGAGEMENTS

	Governance	Leadership & Succession	Strategy	Performance	Reporting & Communication	Capital Management	M&A and Corp Action
COMPANY A	✔	✔	✔	✔	✔	✔	
COMPANY B	✔	✔	✔	✔	✔	✔	
COMPANY C	✔	✔	✔	✔	✔		
COMPANY D		✔		✔	✔	✔	
COMPANY E	✔	✔			✔		✔
COMPANY F	✔		✔	✔	✔	✔	
COMPANY G			✔		✔	✔	
COMPANY H	✔						✔
COMPANY I						✔	✔

Examples of tangible outcomes from these engagement to date, include:

- Comprehensive succession plans announced, involving executive and non-executive directors
- Corporate strategy re-articulated to market, responding to in-depth feedback
- Detailed roadmaps launched by companies to address operational performance
- Improved visibility and clarity over capital allocation plans
- Commitments to improve company reporting, including KPIs and accounting policies

RECOMMENDATION 4:

MORE FORMALLY INCORPORATE A FOCUS ON LONG-TERM VALUE CREATION AND PRODUCTIVITY INTO ENGAGEMENT PRACTICES

ACTIONS:

Seek wider support and financing for the work of the Investor Forum by launching an independent membership fee.

The Investor Forum was developed to address the impediments to shareholder engagement elaborated above, including by delivering a re-balance in focus from AGM-related governance to more long-term strategic engagement. The Steering Committee was encouraged by the Forum's progress in its first full year in operation. However, for its work programme to be properly embedded into practices more broadly and appropriately resourced, it was acknowledged that it would need to be put on a sustainable financial footing.

As a result of this, during February 2016, the Investor Forum accelerated its plan to seek formal funding from its original members. Through this process it has confirmed[25] that it has secured a funding commitment from 19 leading asset managers and asset owners. These institutions have led the way by committing to resource the Forum's work for the next three years, showing their support for best practice in collective engagement and a long-term approach to investing in UK PLC.

Support asset managers in the public reporting of stewardship activities.

The IA will continue to work with its members to enhance their public disclosures on their stewardship activities. Presently, the IA is developing a set of guidelines, the Stewardship Reporting Framework, to assist members when they publicly report on their stewardship activities. This may include case studies of engagements with individual companies, which will include instances of engagement relating to corporate productivity drivers, capital management and other long term value creation issues.

Separately, the FRC has undertaken a review of the quality of Stewardship Code signatories' statements and reporting on engagement activities. The IA will seek to understand how its reporting framework can complement the FRC's proposed tiering system. The FRC are currently due to review the Stewardship Code next in 2018 and the IA will engage with the FRC on how long-term value creation and productivity issues can be better incorporated into the Stewardship Code.

REVIEW:

- In 2016, in partnership with the Institute of Chartered Secretaries and Administrators (ICSA) and Pensions and Lifetime Savings Association (PLSA), the IA will survey asset owners, companies and investment managers on stewardship practices. This will be designed to incorporate questions on the extent to which productivity and capital management issues have received greater prominence in engagement activities. In addition, the IA will review the stewardship disclosures by investment managers in 2017 to see if the activities which they disclose include engagements on productivity, capital management and other long-term value creation issues.
- The Investor Forum will also be issuing an Annual Review of its activities, which will include an update on its membership uptake, the types of engagements being undertaken and the level of involvement from its members.

[25] http://media.wix.com/ugd/1cf1e4_322312c5fa69464ca4fcbc0130e5175f.pdf

3 SIMPLIFY BEHAVIOURAL INCENTIVES AND THE INVESTMENT CHAIN

SUPPORTING PRINCIPLE

THE INVESTMENT INDUSTRY WILL WORK TO ENSURE THAT THE AGREED INCENTIVES AND GOVERNANCE OF THE INVESTMENT CHAIN ENSURE A CLEAR ALIGNMENT WITH CLIENTS' LONG-TERM INVESTMENT OBJECTIVES.

INTRODUCTION

The investment chain is a term often used to describe the structure of shareholding of listed companies, reflecting that there is chain of intermediation from beneficial owners, the 'savers', to the asset managers, the ultimate portfolio decision-maker. This is the system by which savings are channelled from households, invested by asset managers, and ensures the supply of finance to meet the growing investment needs of the economy.

While there has been an explosion of intermediation in equity investment, driven both by a desire for greater professionalism and efficiency, the Kay Review concluded that there had also been a decline in trust and confidence in the investment chain. The Kay Review provided a comprehensive analysis of the agency problems connected with the investment chain of intermediation, including the direct and indirect impediments to adopting a long-term approach.

However one aspect of the investment chain that the Steering Committee believes requires further consideration is the manner in which the relationship between asset owners and asset managers is governed. This is critical juncture in determining portfolio strategies. It should be formulated in a way that ensures that asset managers are able to meet their clients' investment needs and focus capital on the long term.

INVESTMENT MANDATES

Asset owners typically use the term "mandate" to denote a contract with an asset manager that outlines basic investment guidelines, the terms and conditions of engagement, the fee structure, and the as-signed performance evaluation. In this way, they are the primary mechanism for mitigating the principal-agent problems that may arise between asset owners and managers.

The mandate states the investment objectives and risk appetite to give effect to the statement of investment principles. While the relevant parameters of the investment strategy will also be guided by solvency regulation, which is discussed under Section 5 of the Action Plan, the mandate is a critical juncture in the chain of intermediation and has material influence over market practice and behaviour.

There is a risk that mandates or the Statements of Investment Principles, which the Pensions Regulator's guidance states should be reviewed at least every three years, inadvertently embed a short-term approach as a result of the manner and frequency of how performance is assessed. The time horizons used for decisions to hire or review investment managers are generally significantly shorter than the time horizon over which the saver, or the corporate sponsor of a pension scheme, is looking to maximise a return and meet its liabilities.

To illustrate, 70 percent of the respondents to a 2013 CFA Institute survey of European investors cited short-period evaluation cycles by asset owners as an impediment to long-term investing. Warren (2014)[26] cites further evidence on the extent to which the length of the evaluation period is a key determinant of the investment horizon and also highlights evidence that suggests the focus on relative performance of managers – typified by the use of market benchmarks and rankings – has the effect of encouraging short-term behaviour.

A further potential driver of short-termism may arise from what many asset managers perceive to be a structural conflict of interest in the way that investment consultants derive their fees from asset owner clients. For example, fees can be paid on the frequency of performance evaluation and mandate review or tender. In this way there is the risk of there being a commercial incentive to advise clients to set investment mandates with frequent performance evaluation and set contracts short in duration.

The Steering Committee concluded that the current approach to setting and reviewing SIPs and the mandates that ensue from them was not always conducive to providing an investment framework that supports long-term investment by fund managers. We encountered frequent feedback that mandates too often embed a short-term approach. This focused on:

- Excessive use of relative benchmarked performance and unnecessarily restrictive tracking error requirements,
- Frequent performance assessment over short intervals (e.g. quarterly),
- Contracts that can be excessively short in duration, and
- Silence on the intended approach to stewardship and approach to long-term investment.

ROLE OF INVESTMENT CONSULTANTS

Institutional investors often rely on the advice of investment consultants in making their investment decisions. The requirement in the 1995 Pensions Act to formulate a Statement of Investment Principles along with a requirement to take investment advice[27] formalises the role of the consultant in the investment chain. Investment consultants therefore play a central role in the market for institutional asset management, acting as 'gatekeepers' to the client.

They typically provide the following services:

- Development of client's investment objectives and investment policy statements
- Benchmark selection
- Asset allocation advice
- Manager selection
- Fiduciary management

In this regard the process by which investment managers win institutional business involves them being intermediated by the consultant, which subjects them to a thorough and challenging appraisal before a mandate is won.

It is clear why the role of the investment consultant is so important. Even where clients have the skills and knowledge to take investment decisions, they may not have the time to conduct the quantitative and qualitative research that consultants do. With so many investment managers in the marketplace, consultants are therefore an important intermediary, matching asset managers to their clients' investment needs and objectives. They have a significant effect on flows into and out of institutional investment products[28].

[26] G Warren (2014) *Long-Term Investing: What determines Investment Horizon?* Centre for International Finance and Regulation Research Working Paper.

[27] Section 36(3) of the Pensions Act 1995 covers advice and requires that trustees must obtain and consider proper advice on whether the scheme's investments are suitable and suitably diversified and in line with its statement of investment principles. Advice must be obtained from a suitably qualified person though the requirement for that to be from a person authorised under the Financial Services Act 1986, which is limited to specified activities and not the bulk of consultants' work.

[28] T. Jenkinson, H. Jones and J. V. Martinez (2015) *Picking Winners? Investment Consultants' Recommendations of Fund Managers*. Journal of Finance (forthcoming).

In 2013/14, the Law Commission undertook a major review[29] of how the law of fiduciary duties apply to investment intermediaries and evaluated whether the law works in the interests of the ultimate beneficiaries. The Kay Review had identified uncertainties and misunderstandings on the part of trustees and advisers, and a concern that they may be incorrectly interpreting fiduciary duties too narrowly as a requirement to maximise short-term financial returns. The Law Commission was clear that trustees have a duty to consider any factors, including environmental, social or governance factors, where they are, or may be, financially material to the performance of an investment – including over the long-term. The Law Commission made clear that there is no impediment to trustees adopting a stewardship approach in this context.

However, the report highlighted a number of concerns relating to the role of investment consultants. While investment consultants play an important role in advising asset owners on key asset allocation and investment decisions, due to the 'generic' nature of their advice, they remain unregulated and not subject to the same level of fiduciary duties.

Investment consultants are integral in advising asset owners on how their long-term investment objectives are best achieved, including ensuring that their relationships with investment managers are governed in a way that supports those objectives. It is therefore important that the incentive to remain unregulated by providing generic advice does not inadvertently lead to a restrictive approach to the construction of mandates or performance evaluation.

More widely, there is an important opportunity for the investment consultant industry to work collaboratively with asset owners and investment managers to demonstrate how they ensure an appropriately long-term approach and consideration of stewardship-related responsibilities.

While this will be partly achieved through participation in the Working Group proposed to develop best practice guidance on SIP and mandate design, given the importance of their role, there remains an important onus on investment consultants to demonstrate proactively their approach in this respect.

RECOMMENDATION 5:

ENSURE THAT THE RELATIONSHIP BETWEEN ASSET OWNERS AND INVESTMENT MANAGERS IS GOVERNED IN WAY THAT DOES NOT INADVERTENTLY EMBED A SHORT-TERM FOCUS

ACTIONS:

Work with the Pensions Regulator, the PLSA, and investment consultants to develop best-practice guidance on how stewardship and long-term incentives can be better incorporated into the Statement of Investment Principles and Mandate design.

The IA will shortly launch a multi-stakeholder Working Group to oversee the development of this guidance paper. The Working Group will consider all aspects associated with reorienting portfolio strategies and stewardship activities under mandate and SIP best practice. Given the number of stakeholders and the wide remit of the review, it is expected that the best practice guidance will be published in approximately 18 months' time. The review will consider:

- How the statement of investment beliefs can best incorporate the importance of stewardship and long-term investment approaches;
- How risk appetite can be articulated in a way that it encompasses an appreciation of more than short-term volatility and tracking error, and encompasses real economic risk over the long term;
- How benchmarks can be selected and constructed to focus on long-term value creation;
- How the respective stewardship activities and responsibilities can be best specified and clarified between the asset owner and the asset manager;
- How to evaluate the long-term performance of asset managers, with a focus on process, behaviours, and consistency with long-term outcomes; and
- How the investment mandate can operate better as a mutual mechanism for the alignment of behaviours and objectives, (including key issues such as the time horizons in which performance of managers is to be assessed) rather than principally existing as an expression of legal responsibilities and powers.

[29] Fiduciary Duties of Investment Intermediaries. Law Commission Paper No 350.

Investment consultants are encouraged to issue public position statements describing how their activities support the provision of long-term investment approaches and stewardship in mandate design and performance evaluation.

REVIEW:

- For the three year progress review of the Action Plan, the IA will undertake a survey of members and asset owners to establish if there has been change in practices in the wording of the statement of investment principles and mandates.
- The IA will review if investment consultants have issued public position statements on how they support long-term investment approaches and stewardship by their clients.

INVESTMENT IN DEFINED CONTRIBUTION PENSION SCHEMES

In the Defined Contribution (DC) world, provision is split between trust and contract-based schemes, with the requirement to produce a Statement of Investment Principles only applying to the trust-based segment of the market.

The DC market, with its structure of individual accounts and default investment strategies is in any case more decentralised than the Defined Benefit sector – where any conscious investment choice is made, it is done so by the member. The role of trustees and Independent Governance Committees in contract-based pensions is to provide a menu of investment options, including an appropriate default strategy in schemes used for the purposes of automatic enrolment. In practice the vast majority of members simply go into the default strategy, making no active investment choice. The design of the default arrangement is therefore of vital importance in DC schemes.

The current regulatory and market environment for DC investment could be optimised to allow DC investors to fully realise the benefits of being long term investors. This could include looking at ways to make illiquid assets, such as infrastructure, Venture Capital or Private Equity more accessible to DC savers as well as considering whether the 'permitted links' rules that govern unit-linked investments (commonly used in DC) fully allow DC savers to benefit from being long term investors.

A particular issue arises in this regard with respect to the unequal treatment in FCA rules of DB and DC trustees as unit-linked policyholders, whereby the latter face greater restrictions on their permitted investments. This may preclude DC savers from being able to benefit from longer term, less liquid assets. This may be exacerbated by current market practice in DC schemes to provide investors with daily liquidity – something which in investment terms may be unnecessary when their investment horizon is much longer.

RECOMMENDATION 6:

CONSIDERATION OF HOW GREATER OPPORTUNITIES FOR LONG-TERM INVESTMENT CAN BE MADE AVAILABLE TO INVESTORS IN DEFINED CONTRIBUTION SCHEMES

ACTIONS:

Establish a Working Group of key stakeholders to consider the key regulatory and market barriers to creating a DC investment environment more suited to long-term investment.

The working group will be established within 3 months of the publication of the Action Plan, and will consider whether there are any changes to regulation and market practice that will create greater opportunities for long-term investment in DC plans.

REVIEW:

- The Working Group will publish a report setting out the findings of its work within 18 months of the publication of the Action Plan. The IA will provide secretariat to the Working Group and implement its recommendations where appropriate.

INVESTMENT HORIZONS

While it is important to ensure the right incentive framework is set for the portfolio manager, and that this aligns with the investment horizon of the asset owner client, it is also important to seek better clarity on the actual investment horizons of asset managers.

In recent financial commentary regarding the interaction of investors with companies on capital management and buybacks, a growing number of commentators have focused on the average portfolio turnover of the whole market.

This number is widely referred to as evidence of short-termism in markets and has relevance to the role of investors in contributing to productivity. This is important as incorrect conclusions on portfolio turnover may distort the debate over the necessary reforms to corporate governance and stewardship more widely. Our analysis suggests that looking at turnover data in isolation is misleading.

Investment managers are one subset of many market participants, which includes hedge funds, the proprietary trading desks of investment banks and independent high frequency traders. The asset weight of investment managers in the UK equity market (approx. 40 percent) is not reflected in estimates of trading volume, where long-only investors are thought to account for only 25 percent of daily turnover.

In other words, estimates of market turnover derived from the aggregate trading data of stock exchanges are a reflection of the wider market not of the behaviour of investment managers specifically, and it would be misleading to derive any conclusions in this regard. This analysis also fails to take account of flows into or out of funds, which will distort overall market turnover figures.

When the IA reviewed the holding periods of its members based on stamp duty receipts in response to the Kay Review in 2012, the implied average investment holding period was 3.6 years. Analysis based on more recent stamp duty receipt data suggests an investor holding period of around 4 years but other (forthcoming) research, would suggest that for asset managers this period may be longer.

RECOMMENDATION 7:

FOSTER IMPROVED UNDERSTANDING OF THE INVESTMENT HORIZONS OF INVESTMENT MANAGERS

ACTIONS:

Examine methodologies for calculating average holding periods with a view to developing a standard approach across the industry.

The IA will undertake further internal research in this area and draw on independent expertise as to how a consistent and robust methodology for presenting holding period information might be developed. As part of this process, the IA will set up a Working Group to explore the issue with industry and external stakeholders. It will aim to issue preliminary findings by the end of 2016.

REVIEW:

In 2017, the IA will explore how a new metric could be adopted and presented.

EXECUTIVE REMUNERATION

There is extensive research on the importance of effective executive management and all-employee incentives for promoting the long-term success of companies, including their ability, and willingness, to research and develop new products. There was also a great deal of research linking certain remuneration structures with increases and decreases in capital expenditures, including investment in research and development.

The Steering Committee referred to the negative perverse incentives created by poorly structured remuneration arrangements. This was seen to contribute to a short term approach by executive directors. Poorly designed incentive schemes can act as a disincentive to invest in capital expenditure and Research & Development. They can also provide a perverse incentive to favour short term outcomes over longer-term value creation, and therefore provide a management incentive to invest in a pro- rather than counter-cyclical way.

In September 2015, the IA announced the establishment of an independent working group to consider the current structures of Executive Remuneration in the UK. The Executive Remuneration Working Group was formed given the growing view from investors, companies and individual directors that the current structures of executive remuneration are too complex.

This complexity can create perverse incentives for executives and can make remuneration difficult for investors, and, in many cases, for executives, to understand. There is increasing evidence that executives are not incentivised by the current structures, and the link between pay and performance is often oblique. Investors and remuneration committees are therefore unsure that remuneration is currently serving the desired purpose.

For this reason the Working Group has been tasked with seeking to establish a simpler structure of executive remuneration which could gain market traction in the UK. The Working Group[30] will bring forward proposals in early summer 2016.

[30] The Working Group comprises a company Chairman, a Remuneration Committee Chairman, a Chief Executive, a CEO of an Asset Manager and a senior representative of Pension Funds and Private Equity.

RECOMMENDATION 8:

ENSURE THAT EXECUTIVE REMUNERATION STRUCTURES ARE ALIGNED TO LONG-TERM DECISION MAKING

ACTIONS:

Consider the findings of the Executive Remuneration Working Group's review of executive remuneration structures and launch an extensive programme of engagement with listed companies.

The IA will review the findings of the independent Executive Remuneration Working Group following their publication in early summer 2016. The IA will then assess whether to amend its Principles of Remuneration.

REVIEW:

- The majority of UK Listed Companies are due to renew their triennial Remuneration Policies at their 2017 AGMs. The IA will assess whether the recommendations of the Executive Remuneration Working Group have been taken up by companies after the 2017 AGM season.

ASSET MANAGER INCENTIVES

Unlike other UK-listed companies, the remuneration of asset managers in the UK is subject to a number of controls under EU Law. Since 2011, EU regulations have restricted and controlled the remuneration of asset managers seeking to align their interests with those of their clients and to minimise risk. These EU rules are now embedded in the FCA Remuneration Code which is part of the FCA handbook.

4 DEVELOP EFFICIENT AND DIVERSE CAPITAL MARKETS

SUPPORTING PRINCIPLE

AS A KEY CAPITAL MARKET PARTICIPANT, THE INVESTMENT INDUSTRY HAS A VITAL ROLE IN THE DEVELOPMENT OF ASSET CLASSES AND THE EFFICIENT FUNCTIONING OF CAPITAL MARKETS.

INTRODUCTION

Capital markets complement the traditional and central role of banks as lending entities. A well-functioning capital market facilitates the efficient allocation of funds from end-investors to companies and projects in need of capital to grow and invest. Without efficient capital markets, long-term investment relies on a narrow set of financial instruments, including many with short-dated maturities. Taking steps to improve the efficiency of the capital raising process (equity and non-equity) and to expand companies' access to suitable financing options is a crucial part of ensuring that long-term investment is sustainable and sound.

> "PRUDENTIAL AND M&G ARE COMMITTED TO LENDING TO BUSINESSES AND INFRASTRUCTURE PROJECTS THAT BENEFIT THE BRITISH ECONOMY. WHETHER IT IS BUILDING HOSPITALS, SUCH AS LIVERPOOL'S ALDER HEY CHILDREN'S HOSPITAL AND EDINBURGH'S ROYAL HOSPITAL FOR SICK CHILDREN, OR FINANCING SOLAR PARKS THAT POWER OVER 90,000 HOMES, WE ARE PROUD TO PLAY OUR PART. SINCE DECEMBER 2014, WE HAVE LENT OVER £1 BILLION FOR SUCH PROJECTS."

Simon Pilcher,
Chief Executive, Fixed Income,
M&G Investments

INITIAL PUBLIC OFFERINGS

Equity financing through the capital markets plays a crucial role in the economy. Equity capital has a continuing claim on corporate earnings and can be used to finance projects with uncertain and long-term returns, including research and product development. Companies need equity to invest and grow and to generate the returns needed to service debt and other forms of capital.

Following the financial crisis, there were expressions of discontent in the market with regard to the process by which private companies offer the first sale of stock to the public. These concerns led to a perception among some commentators that the initial public offering process in the UK was broken. Against this background, the IA's Capital Markets team conducted an extensive review of the IPO process involving a wide range of market participants including, issuers, banks, lawyers and independent advisers and published the "Encouraging Equity Investment" report[31].

During the review it was found that on the whole, market participants did not believe that the UK model was fundamentally broken. Rather, the negative perception of the IPO market prevailed because its health and success relies on the confidence and momentum of the general market. Nonetheless, the Report identified a number of areas in a typical UK IPO that can be addressed with the aim of improving the efficiency and competitiveness of the process.

[31] ABI (2013) *Encouraging Equity Investment: Facilitation of Efficient Equity Capital Raising in the UK Market.* Available at: www.abi.org.uk

The IPO process starts with a very substantial information asymmetry between the issuer/vendor and the investor. The whole of the process should be designed to help rectify this imbalance through education of the investors as to the drivers of the business, the issuer's positioning within a sector or market, finding out more about the management team and the issuer's key attributes as to why it will make a good investment for any purchaser.

To address this imbalance, the Report set out a number of recommendations that were endorsed by Lord Myners in his Independent Review for the Secretary of State for Business, Innovation and skills on "IPOs and Book building in Future HM Government Primary Share Disposals", including:

- Encourage the practice of early engagement by issuers and vendors with investors up to a year or more before a planned IPO;
- Early publication of Prospectuses;
- Elimination of the research blackout period (the market practice of separating pre-deal research and the prospectus);
- Increased publication of independent research by:
    - Allowing greater access for non-connected analysts to the IPO analysts' presentation or a subsequent similar presentation, such as they are able to have the same information as connected analysts, or
    - Allowing non-connected analysts to publish and distribute research with reference to a prospectus that has been fully approved by the UKLA and published immediately after the Intention to Float announcement ("ITF").

More should be done to adopt these recommendations and to ensure that the IPO process addresses the information asymmetry that exists in favour of issuers and vendors at the expense of investors.

RECOMMENDATION 9:

ENCOURAGE EQUITY INVESTMENT AND IMPROVE THE EQUITY OFFERING PROCESS

ACTIONS:

Develop earlier engagement between institutional investors and small and mid-size early stage pre-IPO companies.

The practice of early engagement should be seen as integral part of the IPO process. The concept of "pilot fishing", or engagement with a small number of selected investors a few weeks before IPO launch, has been around for almost a decade and is helpful in gaining market feedback on possible pricing. However, investors are very clear that they would prefer to meet companies up to a year or more before a potential IPO in order to gain familiarity with the business and the drivers of profitability and to establish a relationship with the management. For companies and their advisers, early engagement would be helpful in developing the investment case, and preparing the company and management for the public market.

Direct engagement with investors could be a particularly useful exercise for small and mid-size pre-IPO companies considering listing on a UK public equity market. Admission to a public equity market is a radical transformation for any private company with investors expecting a high standard of corporate governance, disclosure and transparency, but small and mid-size corporations generally do not get broad access to advisors and investors to benefit from their insights and advice. To address this and to provide support for growth in this dynamic part of UK business, the IA commits to work with the Quoted Companies Alliance ("QCA") to identify small and mid-cap pre-IPO companies and to develop a dedicated engagement programme to prepare such companies and their management for the public market.

Lower the cost of issuing equity capital and removing the information asymmetry that exists at the expense of investors.

To achieve this the IA is engaging with key representatives from the FCA, HM Treasury, LSE and investment banks to:

- Eliminate the market practice of separating pre-deal, connected research and the prospectus (the so called "research blackout period");
- Publish the prospectus earlier in the IPO process to enable investors to be better prepared for the management roadshow and to give more incisive feedback on the company and its valuation; and
- Promote the publication of independent research.

Engage with the European Commissions on the proposed Prospectus Regulation.

The IA will engage with relevant stakeholders on the proposed Prospectus Regulation with a focus on making it easier for companies to access equity capital both at IPO and on the secondary markets whilst, at the same time, maintaining important investor protections. For example, we welcome all efforts to facilitate the timely publication and easy access to prospectuses and to ensure that all investors receive all necessary information to make sound and well-informed investment decisions.

Engage with key stakeholders to improve and support the efficiency of the secondary market capital raising process whilst maintaining investor protections.

The concept of pre-emption is widely acknowledged as a great strength of raising equity capital in the UK. There is also widespread acknowledgment that while it can sometimes appear overly structured to an outsider, the system works well and is flexible enough to be able to recapitalise companies in times of significant financial stress and crisis (as demonstrated in 2008/09).

In 2015, the Pre-Emption Group published a revised Statement of Principles for the disapplication of Pre-Emption Rights. The revised statement provides a framework for early and effective dialogue between company and its shareholders, takes account of market changes and clarifies that the statement applies to all issues of equity securities that are undertaken to raise cash for the issuers, irrespective of the legal form of the transaction. The Statement of Principles also creates flexibility to undertake non-pre-emptive issuance of equity securities in connection of acquisitions and specified capital investments.

As a member of the Pre-emption Group, the IA endorses the recently published Principles and will support any further clarifications or education needed to embed the Principles as market practice.

REVIEW:

- By the end of 2016, the IA and Quoted Companies Alliance will publish a plan for identifying and engaging with small and mid-cap pre-IPO companies.
- The IA IVIS team will monitor the implementation of the revised Pre-Emption Group Statement of Principles on an on-going basis and report on adherence to the Principles to shareholders.
- If no progress is achieved on the elimination of research blackout period and early publication of IPO prospectuses by the end of 2016, the IA will host an industry roundtable to discuss and address the lack of progress.

FIXED INCOME MARKETS

A stable, well-functioning bond market is a critical part of the UK financial market infrastructure, providing capital for issuers and investment opportunities for a broad range of savers and investors. Therefore, it is in the interest of all market participants to develop and maintain practices which promote the fairness and effectiveness of the market, and hence support the financing of the broader economy.

Following the financial crisis, new capital and liquidity rules have made it more expensive and less attractive for banks to provide loans with long-term dated maturities. Between 2000 and 2007, average net lending by banks to UK non-financial corporates was £38 billion per year. Since 2009, net lending has been minus £17 billion per year. As a result, large corporates have turned to fixed income markets as an alternative to bank lending. Between 2000 and 2007 net issuance by UK private non-financial corporates averaged £13 billion per year. Between 2009 and 2015, this increased to £30 billion per year. Today there are over £400 billion of bonds outstanding issued by UK non-financial corporates[32].

Investment managers have played a key role in facilitating this shift in debt finance from bank to non-bank lending and the IA has been keen to ensure that market practice in fixed income markets continues to evolve to ensure that public debt markets remain fair and effective, and provide the right protections for investors to invest over the long term. To support this aim, the IA has published a:

- Statement of Best Practice in New Fixed Income Transactions[33]; and
- Position Paper on Consent Fees, which addresses how these fees are used to incentivise bondholders to vote in favour of proposed amendments to the terms and conditions of an issuers' debt securities[34].
- The IA is also taking steps to ensure that debt investors are getting prospectuses on time to ensure that they have enough time to go through the terms and conditions before they place an order. This is of particular importance to insurers that apply the Solvency II Matching Adjustment (MA) to their portfolios. The MA sets out asset eligibility criteria that insurers need to consider before investing in a fixed income instrument. However, if insurers do not receive this information with enough time to assess the asset eligibility they will have no choice but purchase the instrument in the secondary market, often at a premium.

While most businesses raise funds predominantly in the public bond markets, other channels, including private placements and direct lending, are increasingly being used. The investment industry supports the development of these markets and participation by investment managers is on the increase.

SECURITISATION

Securitisation[35] is an important element of well-functioning capital markets. It creates a bridge between bank and non-bank financial institutions and capital markets with an indirect benefit for the real economy through for example, less expensive loans, business finance mortgages and credit cards.

Soundly structured securitisation is an important channel for diversifying funding sources and allocating risk more efficiently within the financial system. It allows for a broader distribution of financial sector risk by allowing banks to access a broader range of investors by structuring the securitisation to meet investors' risk appetite and preferences. This, in turn, can help to free up bank balance sheets to allow for further lending to the economy. Securitisation also allows non-bank financial institutions to raise funding for their real economy lending, thereby providing an alternative to bank lending.

32 C. Salmon (2015) *Investing in capital markets.* Speech at Association of Corporate Treasurers Corporate Funding Conference, London, 28 October 2015. Available at: http://www.bankofengland.co.uk/publications/Pages/speeches/2015/856.aspx

33 https://www.ivis.co.uk/guidelines

34 Ibid.

35 Securitisation refers to transactions that enable a lender – typically a bank – to refinance a set of loans or assets (e.g. mortgages, auto leases, consumer loans, credit cards) by converting them into securities. The lender pools and repackages a portfolio of its loans, and sometimes organising them into different risk categories, tailored to the risk/reward appetite of investors. Returns to investors are generated from the cash flows of the underlying loans. These markets are not for retail investors.

However, the reputation of securitisation has been severely tarnished by the financial crisis, reflecting the prominent role of asset backed securities involving complex structures and poorly underwritten loans in precipitating distress. While such practices were particularly prevalent in the US, the level of market placed issuance in the EU has remained low in the aftermath of the crisis. This is due to a number of factors including, macroeconomic conditions, the availability of cheaper funding sources, regulatory barriers and uncertainties and the stigma that investors still attach to the asset class.

In response to the slow recovery of securitisation markets, the European Commission has committed to develop a high quality securitisation market that will constitute a building block of the Capital Markets Union and will contribute to the European Commission's priority objective to support a return to sustainable growth and job creation. A high-quality EU securitisation framework will promote further integration of EU financial markets, help diversify funding sources and unlock capital. This will make it easier to finance businesses and, in some circumstances, is likely to lower the cost of capital.

The European Commission hopes to achieve this by developing a set of criteria to identify simple, transparent and standard (STS) securitisations that should provide confidence to investors and help parties evaluate the risks relating to the securitisation.

The Investment Association has been actively engaged on this initiative both in the UK and Europe to encourage the Commission to facilitate more investment into this asset class. A robust framework will depend on:

- The criteria for STS securitisations being robust but not unduly restrictive;
- Investor confidence in the certification mechanisms; and
- Appropriately calibrated capital charges for insurance companies.

PRIVATE PLACEMENTS AND INFRASTRUCTURE

As previously noted, the volume of traditional bank lending to SMEs and infrastructure projects has been declining. In addition, SME and infrastructure projects are unable to access the public bond markets due to the need for institutional investors to invest in liquid securities. This restricts the size of the majority of wholesale bond issuances to greater than c.£150m. The mark-to-market requirements of defined contribution pension schemes combined with the fact that investors are often benchmarked against indices (which often limit constituents to issuers with an external credit rating), reinforces the bias towards large, highly traded, liquid issues. This has resulted in concern amongst policymakers that SMEs and infrastructure projects are not getting the funding necessary to sustain long-term economic growth. Against this backdrop, policymakers are increasingly focusing on alternative finance as a way to complement bank lending.

In the past, institutional investors have provided indirect financing to the wider economy through the purchase of bank debt. Increasingly these investors are seeking opportunities for direct lending as a means to diversify their investments away from existing corporate bond and equity markets. Given their long-dated liabilities they are prepared to invest in longer-dated SME and infrastructure risk with the right risk and return profile, as long as the risks are transparent and within their risk appetite. This can be achieved by increased investments in private placements.

In 2014 the Investment Association and its members worked with Government to explore how investment in private placements can be increased. This resulted in the Government proposing an exemption from withholding tax for interest on private placements. As a result, Investment Association members were able to commit to £9billion in UK Private Placement and other forms of direct lending.

CASE STUDY

QUALIFYING PRIVATE PLACEMENT EXEMPTION – ALLIANZ GLOBAL INVESTORS

A particularly important recent innovation was the introduction of the Qualifying Private Placement (QPP) exemption from withholding tax. This allows institutional investors resident in recognised jurisdictions to invest in UK infrastructure projects without the cost and complexity for infrastructure borrowers of needing to list project bonds in order to attract international investment alongside domestic investment. Crucially, this QPP exemption puts private placements on a level playing field with listed corporate bonds.

The measure, first announced in the Autumn Statement in late 2014, became effective on 1 January 2016 and our clients are seeking to acquire the first QPP infrastructure bonds during March and April to finance further new infrastructure investment, enabling the recycling of bank lending away from existing infrastructure loans to other parts of the economy.

“ALLIANZGI IS DELIGHTED TO PLAY AN ACTIVE ROLE IN SUPPORT OF THE CITY OF LONDON AND CHANCELLOR'S EFFORTS TO HELP BOOST UK PRODUCTIVITY. WORKING CLOSELY WITH OUR CLIENTS AND COUNTERPARTIES AT HM TREASURY AND HMRC, WE HAVE ALREADY BEEN ABLE TO DELIVER PENSION FUND DEBT INVESTMENT INTO NEW-BUILD UK INFRASTRUCTURE PROJECTS, INCLUDING THE M8 AND ABERDEEN WESTERN PERIPHERAL ROUTE. IT IS NOW WIDELY RECOGNISED THAT INVESTMENT INTO ESSENTIAL INFRASTRUCTURE OF THE SORT WE INVEST IN ON BEHALF OF OUR CLIENTS CAN BOOST ECONOMIC ACTIVITY BY MANY MULTIPLES OF THE COST OF THE NEW ASSETS. AT THE SAME TIME, PENSION FUNDS WHO NEED TO MATCH THEIR LONG-TERM PAYMENT OBLIGATIONS BENEFIT FROM THE OPPORTUNITY TO INVEST IN DOMESTIC ASSETS WITH HIGHER RETURNS THAN TRADITIONAL FIXED INCOME PRODUCTS OFFER.”

Adrian Jones,
Director of Infrastructure Debt,
Allianz Global Investors

The recently launched Pan-European Corporate Private Placement Market Guide has been another positive development for encouraging better practices and the development of the market. The Guide was developed by the International Capital Markets Association and aims to support the development of a pan-European private placement market and builds on existing practices in the bond and bank loan market.

The Investment Association continues to engage with market participants to support the market and highlight investors' appetite in this asset class.

CASE STUDY

INFRASTRUCTURE INVESTMENT – AVIVA INVESTORS

Since 2014, Aviva Investors have committed over £800m to infrastructure projects, including:

Westermost Rough offshore wind transmission
This is a refinancing deal which closed in 2016. The EIB and Aviva provided £128m of 19-year senior debt. The transmission assets connect the 205MW Westermost Rough offshore wind farm, which is owned by Dong Energy, Marubeni and the Green Investment Bank, to the electricity grid. The Westermost Rough Offshore Wind Farm is 8km from the Holderness coast, approximately 25 km north of Spurn Head at the river Humber estuary. The wind farm comprises 35 Siemens 6MW turbines - the first time anywhere in the world that these turbines have been used on a large scale. It was completed in May 2015. The windfarm can provide enough electricity to power around 150,000 UK homes.

Dumfries and Galloway acute hospital
Financing enabled the construction of a new acute hospital at Dumfries. When it opens in 2017, the hospital will have 344 single rooms, an emergency care centre and a new combined theatres complex. New models of care and the latest technologies will enable staff to provide patients with the highest standards of care. The construction and delivery of the new £200m hospital will bring other benefits to the region, including the creation of 150 new jobs, 36 apprenticeships, and opportunities for SMEs to tender for contracts.

Priority Schools Building Programme
Financing arrangements were closed for four of the funding batches in 2015 and the final fifth one in 2016. The deals fund the refurbishment and construction of 46 schools in the North West, North East, Midlands, Hertfordshire, Luton, Reading and Yorkshire. The last deal to close, the Yorkshire batch, involves building seven new secondary schools, four of which are in Bradford.

HOUSING ASSOCIATIONS

Funding via capital markets has become particularly important to housing associations in recent years. This is due to reduced grant funding from the Government and the limited availability of bank funding following the financial crisis and the consequent changes to bank regulation. Capital markets have been able to make up this shortfall.

The sector is an appealing prospect for insurance companies and pension funds due to its strong asset base, predictable income stream, Government support through housing benefits and regulation and a relatively limited range of alternative long-dated sterling-denominated investment opportunities. Asset managers, on behalf of their insurance and pension fund clients, play a key role in funding housing associations. Between 2012/13 and 2014/15 housing associations raised approximately, £19 billion from a variety of sources. Of this amount, £11 billion was raised in the debt capital markets through public bond issuance, private placements and the European Investment Bank.

Investment managers and end investors have a common interest in ensuring that capital market funding can take place in a way that enhances the ability of housing associations to fulfil financing requirements. Such funding is enabled by a range of considerations, at the heart of which sits the need for policy certainty. This is as true for social housing as it would be for any other form of public or quasi-public project, such as infrastructure.

For Housing Associations to access a wider pool of investors, greater transparency from the sector is required to support market confidence. This is particularly the case for housing association governance and performance. Investors are keen to engage with housing associations and will be working through the IA to promote a greater understanding within the sector. This work will focus on why investors value greater transparency, the information that they would like to see publically disclosed and how this information can be effectively distributed to investors.

MUNICIPAL BONDS

Municipal bonds are an attractive asset class for institutional investors looking to match their assets to their long term liabilities. UK municipal bonds would also provide a means for investors currently not investing in infrastructure to gain that exposure to this asset class. For local authorities, a municipal bond market will not only diversify their lending sources, they will enable access to a wider range of capital at competitive market rates. They will also reduce their reliance on central government funding.

As such, our members keen to see the development of a UK Municipal Bond market and welcome the creation of the UK Municipal Bond Agency Plc. This should lower the cost of financing for Local Authorities which will mean that more can be invested into local economies, infrastructure and social housing.

RECOMMENDATION 10:

ENSURE THE EFFICIENT OPERATION OF THE MARKETS FOR OTHER ASSET CLASSES TO ENSURE THE PROVISION OF DIVERSE CAPITAL MARKETS

ACTIONS:

Continue to engage with the European Commission on the proposed Prospectus Regulation to promote the key priorities of asset managers for non-equity securities.

The IA will focus its engagement on:

- The abolition of EUR 100,000 denomination size currently used in the Prospectus Directive to distinguish wholesale disclosures. This threshold, originally conceived as a consumer protection, places many bonds beyond the reach of retail investors, as issuers generally seek the less costly option, but it also has implications on investment managers' duties to treat customers fairly. The minimum denomination required also places Europe at a competitive disadvantage to the US, where the minimum denomination is $1,000; and
- The standardisation of non-equity instrument documentation, including the use of Prospectus Summaries that present all key information and risk factors in a succinct and clear format.

Promote a more efficient new issuance process in fixed income markets and aid secondary market liquidity through the use of clear terminology and standard definitions in covenants for sterling and euro bond issues.

A senior-level industry working group will be convened to consider standardisation of the language and definitions used in bond covenants for sterling and euro bond investment grade issues.

Promote appropriate behaviours and investor expectations in fixed income markets and support the work of the Financial Markets Standards Board and the FCA Debt Markets Forum.

Develop and promote guidelines for Housing Associations raising capital in public markets.

The IA will be publishing guidance to outline investor expectations for governance and disclosure practices from Housing Associations that are frequent capital markets issuers. The IA will be engaging with Housing Associations while developing the guidance, which will be published by September 2016. This will focus on why investors value greater transparency, the information that they would like to see publicly disclosed and how this information can be effectively distributed to investors.

Work with the UK Municipal Agency to promote the development of a UK municipal bond market and highlight the interest of investors in this sector.

Support on-going work to develop European Private Placements and the revival of the securitisation market in UK and Europe.

REVIEW:

- The IA will report on the outcomes of the industry Working Group on bond covenants 12 months following publication.
- The IA commits to publish guidelines for Housing Associations raising capital in the public markets by September 2016 and will engage with the sector to promote and embed investors' views.

5 OVERCOME TAX AND REGULATORY IMPEDIMENTS TO THE PROVISION OF LONG-TERM FINANCE

SUPPORTING PRINCIPLE

THE INVESTMENT INDUSTRY SHOULD CONTRIBUTE TO THE DEBATE ON POTENTIAL TAX AND REGULATORY IMPEDIMENTS TO INVESTMENT SO AS TO ENSURE THE RIGHT LONG-TERM OUTCOMES FOR CLIENTS.

INTRODUCTION

Demand for long-term investment is projected to rise substantially in the coming decade. This is a consequence both of the need for mature economies to address major infrastructure needs and for emerging nations to continue their march towards urbanisation and industrialisation[36]. The global demand for infrastructure investment is estimated to be as high as US$3.7 trillion per annum[37], leading to a global 'infrastructure gap' of US$1 trillion, or 1.4 percent of global GDP. Meeting these investment needs is critical for achieving productivity improvements. However, there are concerns about whether the regulation of capital markets is configured to meet these growing financing needs efficiently.

In theory, pension funds, insurance companies, and other asset owners all have a natural alignment with these long-term financing needs given their long-dated liabilities. This also positions them to look through short-term market volatility and invest in a counter-cyclical way, meaning they have the potential to have a stabilising influence on the financial system. At the end of 2015, global pension funds held assets of approximately US$ 36trn[38] and UK insurers alone held £1.8trn in assets[39].

While investors have different mandates, investment strategies, and knowledge of the markets in which they are investing, regulatory and tax developments remain important factors in shaping both the asset allocation strategies of institutional investors and the funding structures of corporates. Both have important implications for long-term investment and financial stability.

On the supply side, a growing number of companies are raising capital through debt rather than equity. The tax system continues to incentivise businesses to use debt rather than equity finance, and the extent to which this "debt-bias" might contribute to pro-cyclicality and financial instability is increasingly a focus of regulators. On the demand side, there is a concern that solvency regulation may be inadvertently impeding long-term asset allocation strategies. The extent to which both might be linked to pro-cyclical investment outcomes and financial stability, is a matter of continued review by the Bank of England[40].

COMMON DE-RISKING THEMES

There are a number of inter-related factors that are contributing to an overall de-risking theme across capital markets, particularly in relation to the holdings of equity and other longer term forms of capital. Some of these factors are outside the control of the investment industry but have major implications for the traditional sources of capital to the real economy and include:

- **Fiscal consolidation:** Austerity and fiscal consolidation continues to limit governments' ability to fund these and other long-term investments in research and development. In the UK, a further £20 billion of consolation measures are required during 2016[41]. Going forward, the private sector will need to finance more investment into the economy to fill this gap.

[36] OECD (2012), Strategic Transport Infrastructure Needs to 2030, OECD Publishing.

[37] World Economic Forum (May 2013) *Strategic Infrastructure: Steps to Prepare and Accelerate Public-Private Partnerships.* Available at: http://www3.weforum.org/docs/AF13/WEF_AF13_Strategic_Infrastructure_Initiative.pdf

[38] Towers Watson (2015) Global Pensions Asset Study.

[39] ABI (2015) *UK Insurance & Long Term Savings: Key Facts.*

[40] Bank of England and the Procyclicality Working Group discussion paper (July 2014) *Procyclicality and structural trends in investment allocation by insurance companies and pension funds.*

[41] Treasury Summer Budget 2015. Policy Paper: https://www.gov.uk/government/publications/summer-budget-2015/summer-budget-2015

- **Bank deleveraging:** the new capital requirements regime is contributing to a more restrictive lending environment. The aggregate leverage of large internationally active banks declined from 29 times Tier 1 capital in 2011 to 22 times in 2014[42]. Between 2000 and 2007, average net lending by banks to UK non-financial corporates was £38 billion per year. Since 2009, net lending has been minus £17 billion per year. As a result, large corporates have turned to fixed income markets as an alternative to bank lending. While such reductions are helping to reduce the vulnerability of the financial system to shocks, they are also removing a major source of funding to the economy.

- **Shortening bank loan maturities:** New capital and liquidity rules have made it more expensive and less attractive for banks to provide loans with long-term dated maturities. Research shows that loans with maturities of less than one year are the only category of lending that is still growing in the euro area, while loans with maturities greater than five years have been shrinking[43].

- **Demographics:** As investors age in the Unites States and Europe, they are naturally shifting to lower-risk assets, such as fixed income and cash. Future aging will amplify a trend already underway in Europe, where equity holdings have already been reduced from 37 percent to 29 percent of financial assets from 2001 to 2010[44].

But also include factors more directly related to the overall conduct and prudential regulatory framework for asset owners and asset managers. A common theme in all of these is the approach to the measurement and control of investment risk. These regulations are a key aspect of the systemic framework imposed on insurers and pension funds to limit risk taking and ensure that financial obligations to policy holders and pension scheme beneficiaries can be met.

It is appropriate for the protection of consumers that these regulations have some focus on market risk so as to incorporate aspects of shorter-term volatility in valuation and prudential controls. For example there will need to be focus on ensuring provision to savers in extreme market conditions.

However, concerns have been raised that this is placing too much emphasis on immediate, short-term market risk at the expense of informed judgement consistent with clients' investment objectives. This emphasis on short-term market risk is in evidence in different ways and was most commonly highlighted in the following areas:

- **The switch to defined contribution (DC) pensions:** DC pensions are increasingly replacing the defined-benefit model. As a share of all pension assets, defined-contribution plans have risen from 3 percent in 2000 to 40 percent in 2010 in the United Kingdom[45]. According to research from Towers Watson[46], during the last 10 years DC assets globally have grown at a rate of 7.0% p.a. while DB assets have grown at a slower rate of 4.3% p.a. Because participants choose their own asset allocations, these plans typically have a simplified menu of default investment options and have much lower allocations to equities.

- **Solvency regulation:** Changes in regulations in the aftermath of the equity downturn in 2000-2002, and subsequently following the financial crisis of 2007/8, have aimed to incentivise pension funds and insurance companies to reduce their risk profiles and directly consider asset-liability matching in asset allocation decisions, including their demand for corporate debt[48]. This had led to a significant reduction in the proportion of equity investment by the biggest cohort of asset owners.

- **FCA prudential sourcebook:** The FCA's Position Risk Requirements under the Prudential Sourcebook require asset managers to apply risk models that measure risk by reference to short-term volatility (e.g. tracking error relative to an index benchmark). In a similar way, asset allocation models and insurance company market-based risk models commonly measure risk by reference to one year volatility, a measure which reflects the amount of market volatility generated by trading activity, rather than the underlying long-term riskiness of the asset in a way consistent with the investment horizon of the client.

[42] See Basel Committee for Banking Supervision, Basel III Monitoring Report 2015, Table A.16.

[43] G30 Working Group (2013) *Long-term Finance and Economic Growth.*

[44] McKinsey Global Institute (2011) *The Emerging Equity Gap: Growth and Stability in the New Investor Landscape.*

[45] Ibid.

[46] Towers Watson, (2015) Global Pensions Asset Study - 2015

[48] Committee on the Global Financial System, Bank for International Settlements (2007) Institutional Investors, Global Savings and Asset Allocation. CGFS papers no: 27. Available at: http://www.bis.org/publ/cgfs27.pdf

- **Pension fund accounting:** The G30 has also noted that accounting methods may embed a short-term horizon and act as a potential impediment to long-term finance[49]. Pension fund accounting encourages risk-mitigation strategies that have steered defined-benefit funds towards low risk fixed income securities. This is primarily due to the volatility mismatch between how assets are valued compared to liabilities. Assets are valued at fair value, and are therefore subject to short-term volatility in capital markets, whereas liabilities are valued on a discount rate equal to the market yield on AA corporate bonds, and are less liquid and less volatile.

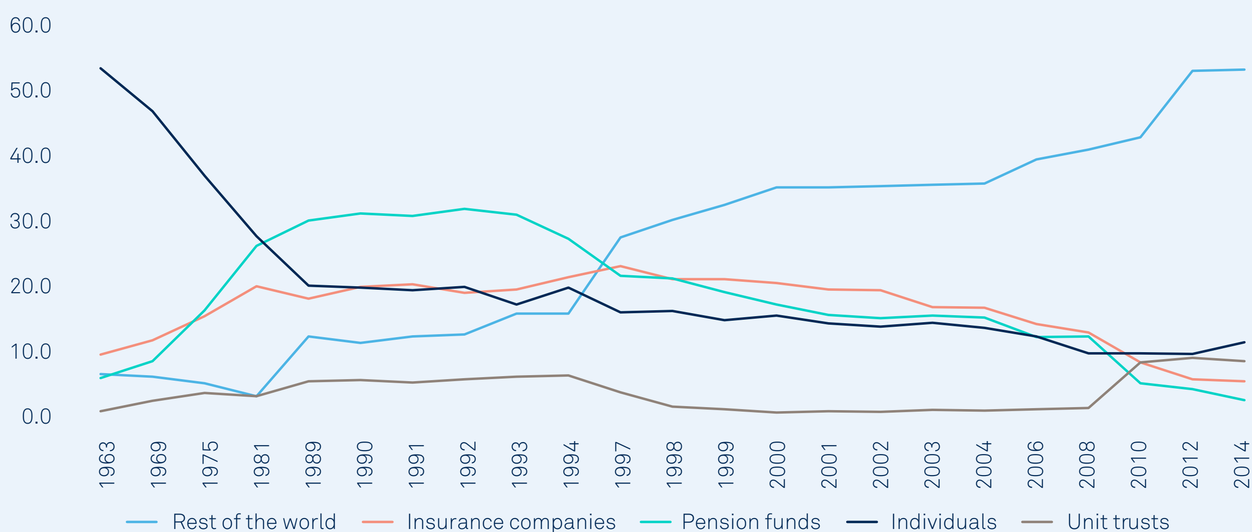
These observations on the approach to risk have major implications for the provision of finance to the real economy, for example leading to a tendency to shift away from less liquid investments and, in some circumstances, restrictions on the types of asset classes.

There is also the risk that an overly prescriptive market risk appetite may result in unnecessary portfolio decision-making in times of market distress, for example selling securities which, although volatile in current market conditions, may be entirely consistent with long-term investment objectives.

In the same way, this may result in amplifying short-term movements in prices, rather than enabling long-term investors to invest counter-cyclically and have a natural stabilising influence over the market.

These observations on the shift from higher-risk, higher-return equity investment to investment in lower-risk fixed income securities are supported by aggregate asset allocation data in the UK, which demonstrate that the nature of investment in the UK has changed dramatically over the last 50 years.

FIGURE 4: HISTORICAL TRENDS IN BENEFICIAL OWNERSHIP – PERCENTAGE OF TOTAL MARKET VALUE OF UK QUOTED SHARES BY SECTOR OF BENEFICIAL OWNER, 1963 TO 2014



Source: Office for National Statistics

Similarly, the Kay Review highlighted concerns over an excessive focus by regulators[50] on short-term market risk, with particular focus on volatility risk, at the expense of informed judgement of longer-term firm-level risks, which are likely to be more consistent with the long-dated investment horizons of clients.

This approach was criticised in the Kay Report: "Risk models used in the regulation of the investment process should focus on risk as perceived by savers, not risk as experienced by market participants. These risks are the failure of their investments to meet their reasonable long-term expectations over the time horizon for which they wish to invest."

48 G30 Working Group (2013) Long-term Finance and Economic Growth

50 For example, under the FCA's Prudential Sourcebook for Investment Firms.

SOLVENCY AND PRUDENTIAL REGULATION

Solvency regulations are a key aspect of the regulatory framework imposed on insurers and pension funds to limit risk taking and ensure that financial obligations to policy holders and pension scheme beneficiaries can be met. However, the way in which investment regulations influence investment behaviour has become an area that has taken on increased focus. The G30 has noted that "potential long-term investors are increasingly constrained in their ability to provide financing" (2013).

There have been significant reforms governing solvency regulation in the last 10 years. In particular, the insurance sector has been rapidly evolving towards more risk-based requirements for capital. However, such market-based risk models place a strong emphasis on volatility risk and trading error relative to a benchmark. While there has been some movement towards the adoption of explicit risk-based funding requirements in pension regulation, there has nonetheless been an increasing emphasis on qualitative elements with respect to risk management and risk-based supervision.

Accordingly, in an effort to de-risk, these investors have tended to shift their asset allocation decisions away from equities to fixed-income securities. For example, between 2001 and 2011, insurers in Western Europe reduced their allocation to equities by 11 percent outside their unit-linked businesses, and correspondingly increased their fixed-income holdings. Allocations to equities in both defined-contribution and defined benefit funds has dropped by 22 percent in the United Kingdom[51]. Moreover, different quantitative restrictions have traditionally been applied for pension funds in many countries, normally stipulating upper limits on investment in specific asset classes, including equity.

Many pension funds face shortfalls that have intensified short-term performance pressures, while they also face risk-mitigation rules that favour low-risk fixed-income securities. For insurers, the G30 argues that in Europe in particular, management led risk-reduction strategies, in part in anticipation of the introduction of Solvency II, may similarly have triggered a shift away from asset classes such as equities.

[51] McKinsey Global Institute (2011) The Emerging Equity Gap: Growth and Stability in the New Investor Landscape.

RECOMMENDATION 11:

ENSURE THAT SOLVENCY AND PRUDENTIAL REGULATION DOES NOT INADVERTENTLY IMPEDE INVESTMENT MANAGERS FROM INVESTING IN A MANNER CONSISTENT WITH THEIR CLIENTS' LONG-TERM INTERESTS

ACTIONS:

Encourage the FCA to undertake a thematic review of whether the approach to market risk in prudential and conduct regulation is resulting in investment decisions that are consistent with the long-term investment objectives of clients.

The IA will engage with the FCA to consider whether specific models in valuation or risk assessment, which are required or implicitly encouraged, are inadvertently resulting in prescriptive investment decision making inconsistent with clients' investment horizons. This could incorporate the judgment of the suitability and appropriateness of investments and the extent to which this balances short-term market risks versus long-term investment objectives.

Convene a multi-stakeholder Working Group to review the extent to which current accounting standards and solvency and prudential regulatory requirements may be resulting in excessive de-risking by insurers and pension funds and impeding the provision of longer-term forms of finance.

Following publication, the IA will seek to establish a Working Group of key stakeholders. This will include an invitation for senior representatives of key stakeholders, including regulators, Government, and representative bodies, including of asset owners and actuaries, to be represented on the Working Group. Following the finalisation of the composition of the Working Group, a formal Terms of Reference will be agreed and will direct the scope and focus of the review. The IA is prepared to provide full secretariat to the Working Group, although it may be appropriate, should they wish, for other institutions to provide secretarial support.

CASE STUDY

STANDARD LIFE INVESTMENTS EUROPEAN INSURANCE SURVEY – PRESSURE AND CHANGE IN THE EUROPEAN INSURANCE SECTOR

During 2015, Standard Life Investments undertook a comprehensive survey to understand and assess the impact of the low-return environment and Solvency II on European insurers[52].

The survey showed that European insurers feel they are unlikely to be able to generate sufficient future returns to meet guaranteed rates for their policyholders and that regulatory modernisation and change may make it more challenging for traditional insurers to make the necessary strategic asset allocation changes.

Around 60 interviews were carried out with senior insurance investment executives, mainly CIOs and CROs, representing over €2.4trn, or around 30%, of pan-European insurance assets under management.

The survey identified five key themes as follows:

1 Increasingly, European insurers may no longer be able to generate sufficient future returns to meet guaranteed rates to policyholders. The expected future annual return (based on existing investment strategies) of 2.4% is below the 2.7% respondents need to meet future policyholder requirements (based on current guarantee levels).

2 In response, many European insurers are considering undertaking significant strategic (SAA) and tactical asset allocation (TAA) changes to improve yield. Risk appetite appears to be rising. Half of insurers expect to reduce sovereign fixed income exposure, while over 60% expect to increase allocations to real estate and/or alternatives, like infrastructure debt and other types of private markets assets. These alternative asset classes were often seen as having relatively attractive Solvency II risk-return characteristics.

3 Insurers' felt that their investment freedom was affected by Solvency II, with 73% of insurers indicating that it may be limiting them in the design of their investment portfolios. Under Solvency II, the taking of asset risk now requires the holding of appropriate risk-capital and a full understanding by the insurer of the asset risks being taken.

4 Outsourcing asset management activity is increasingly attractive, but there are concerns about the limited number of insurance asset managers able to meet complex insurer requirements. 44% of European insurers are looking to outsource the management of one or more asset classes and there is a general trend of outsourcing across all asset classes within the European insurance industry.

5 Insurer business models and profitability are under pressure from a structural shift away from guaranteed savings to unit-linked structures. 43% of insurers stated they were unable to price new guaranteed investment products at competitive rates.

> "EUROPEAN INSURERS' BUSINESS STRATEGIES AND TRADITIONAL BUSINESS MODELS ARE BEING FUNDAMENTALLY CHALLENGED DUE TO THE COMBINATION OF THE LONG-TERM LOW RETURN ENVIRONMENT, SOLVENCY II AND THE ONGOING NEED TO DELIVER ON PROMISED GUARANTEES."

Bruce Porteous,
Investment Director of Insurance Solutions,
Standard Life Investments

[52] http://www.standardlifeinvestments.com/Insurance_Survey_Europe_UK_TCM/getLatest.pdf

"IT IS ALSO IMPORTANT TO REMEMBER THAT SOLVENCY II WAS CONCEIVED AND DEVELOPED IN A VERY DIFFERENT ECONOMIC ENVIRONMENT. SINCE OUR SURVEY COMPLETED, FUNDAMENTAL QUESTIONS ABOUT THE DESIGN AND PERFORMANCE OF THE SOLVENCY II BALANCE SHEET HAVE BEGUN TO BE RAISED, BOTH BY INSURERS AND SUPERVISORS.

AS A CONSEQUENCE, IT SEEMS VERY LIKELY THAT THE SOLVENCY II DEVELOPMENT AND IMPLEMENTATION ISSUES THAT THE EUROPEAN INDUSTRY HAS BEEN WORKING ON OVER RECENT YEARS WILL NOT END ANY TIME SOON. WE REMAIN HOPEFUL THAT FURTHER AMENDMENTS, ENCOURAGING LONG TERM INVESTMENT BY EUROPEAN INSURERS IN IMPORTANT ASSET CLASSES LIKE INFRASTRUCTURE AND SECURITISATIONS, WILL BE INTRODUCED IN DUE COURSE."

Bruce Porteous,
Investment Director of Insurance Solutions,
Standard Life Investments

DEBT BIAS

While there has been concerted efforts to re-risk financial markets and, in particular, reduce leverage in the banking sector, broader measures of debt in the non-financial sector have continued to grow. In aggregate, this has led to higher levels of corporate leverage as measured by the ratio of non-financial corporate debt to GDP[53]. This has led to questions over whether the existing regulatory and fiscal incentives have led to this increase and whether the trend represents a risk to financial stability[54].

High debt levels relative to equity creates leverage which can accentuate losses to owners, and create elevated debt service requirements. This, in turn, can lead to exacerbated cash flow stress, deteriorating creditworthiness and higher corporate default. Moreover spikes in default rates may permeate through the financial system as investors and creditors incur losses. In this way, leverage in the corporate sectors of the economy can represent a systemic vulnerability, because it can act to amplify changes in economic fundamentals[55].

In February 2015, G20 Finance Ministers and Central Bank Governors asked the Financial Stability Board[56] to present a report on the factors that shape the liability structure of corporates focusing on the implications for financial stability. This report highlights the growth of non-financial corporate debt in many countries over the past 15 years.

To the extent that there are high and pro-cyclical levels of corporate leverage that affect a significant number of companies, this may add to pro-cyclicality of the financial system, and hence reduce financial stability. Some studies find that excessive debt can dampen economic growth and can lead to financial crises[57].

53 Financial Stability Board (August 2015) *Corporate funding structures and incentives.*

54 Bank of England and the Procyclicality Working Group discussion paper (July 2014) *Procyclicality and structural trends in investment allocation by insurance companies and pension funds.*

55 Ibid

56 Together with the IMF, OECD, BIS, IOSCO and WBG.

57 C. Reinhart, V. Reinhart, K. Rogoff (2012) Public Debt Overhangs: Advanced Economy Episodes since 1800. Journal of Economic Perspectives, Vol: 26 (3), 69-86.

There are a number of factors contributing to this trend. One of the most cited causes is asymmetry in tax systems that incentivises businesses to use debt rather than equity finance. Generally, interest can be deducted in calculating liability to corporate income tax but returns to equity cannot. Tax systems compensate for this by taxing holders of debt more heavily than holders of equity. However, even if a tax system is designed to preserve symmetry across issuers and holders of securities, this does not remove debt bias in two scenarios:

- Where investors are subject to a different rate of tax, or a different tax regime altogether: most institutional investors (for example pension funds and life insurance companies) are effectively exempt from corporate income tax, which incentivises the use of debt to obtain tax deductions in the issuing company, with no compensating tax charge for the holder
- Profit shifting or BEPS[58]: cross-country differences in corporate income tax rates that can lead corporate groups to conduct internal lending from low-tax countries to high-tax countries, or by locating external borrowings in high-tax countries (although tax authorities are likely to challenge artificial structures that are intended to evade tax).

A sizeable empirical literature finds that tax distortions have a significant and considerable impact on corporate leverage in the nonfinancial sector: one meta-study (calculating a consensus from the full set of studies) suggests that it could lead, at a corporate income tax rate of 40 percent, to leverage ratios being 10 percentage points higher than under a system which was neutral between debt and equity[59].

A reduction in the fiscal bias against equity may be an important consideration in supporting innovation and creating the right macro environment for productive growth. It may also be key to improving the flow of institutional funds into equity issued by both large and smaller companies.

Several policy options are available to limit the tax bias towards debt financing. At its most simplest, a reduction in the rate of corporate income tax reduces the impact of any debt bias in the tax system. This has been the trend in the UK in recent years and it can be expected that the reduction in the headline rate of corporation tax (which is 20%, and will be 18% by 2020 under current government policy) will reduce the debt bias.

Other policy options that have been widely studied and implemented involve limiting deductibility of interest payments or introducing a tax allowance for equity.

Limiting interest deductibility (which, in its most radical form is referred to as Comprehensive Business Income Tax, or "CBIT") is one of the recommendations of the OECD BEPS Action Plan[60], and is currently being proposed across the EU[61] and consulted upon for implementation in the UK[62].

Whilst interest limitation could be an effective tool in combatting tax avoidance and profit shifting, its effect on financial stability is less clear. In particular, used in isolation, it could have an adverse impact on the cost of capital for businesses, as well as a direct adverse impact on debt funding for capital-intensive investments, such as property and infrastructure. While the reduction in the use of debt might reduce the instance corporate default, the increase in cost of capital might increase the likelihood of defaults.

Introducing an allowance for corporate equity (or ACE) was one of the key recommendations of the Mirrlees Review[63] and has been trialled in a number of countries, including recently in Belgium and Italy. While this approach is attractive in dealing with debt bias in corporate finance structures, it erodes the tax base of companies, which has fiscal consequences, and could potentially exacerbate problems with tax avoidance and profit shifting.

[58] Base Erosion and Profit Shifting.

[59] de Mooij (2011) *The Tax Elasticity of Corporate Debt: A Synthesis of Size and Variations.* IMF Working Paper 11/95

[60] http://www.oecd.org/tax/beps-2015-final-reports.htm

[61] http://ec.europa.eu/taxation_customs/taxation/company_tax/anti_tax_avoidance/index_en.htm

[62] https://www.gov.uk/government/consultations/tax-deductibility-of-corporate-interest-expense/tax-deductibility-of-corporate-interest-expense-consultation

[63] http://www.ifs.org.uk/docs/taxbydesign.pdf

Responding to the challenges of debt bias and its impact on cyclical and financial stability, corporate tax avoidance through profit shifting, and erosion of corporate tax bases, might require very different and possibly conflicting approaches.

More generally, public consciousness of corporate tax avoidance has highlighted fundamental concerns with the way the corporate tax system works for multinational enterprises. The attribution of profits to entities within a group using transfer pricing principles is poorly understood, and often difficult to apply to modern business models, where value creating assets and individuals are highly mobile. There is a general perception that companies should be taxed where they operate in a market, rather than the more traditional OECD-based principles of attributing profits to key entrepreneurial risk-taking functions (KERTs) or significant people functions (SPFs).

Another observation that is often made is that the burden of taxation is only ever borne by individuals, and not by companies. Companies are mere tax collection vehicles, but the burden of taxation paid by companies is invariably borne by company owners, and also company employees and customers (through the effects of squeezed margins). It is also relevant that companies pay a wide range of taxes, including in the UK corporate tax, business rates, VAT, employers' NI and the ownership of companies also subject to stamp duty reserve tax, as well as income and capital gains taxes. However, a coherent policy basis behind the various forms of taxation of companies it is not always evident.

Against this backdrop, regulatory developments, such as increased transparency of corporate ownership and the development of automatic exchange of tax information, make it more difficult to hide taxable profits behind the veil of incorporation of a company – one of the key reasons for taxing company profits.

RECOMMENDATION 12:

REVIEW THE CAUSES OF "DEBT-BIAS" AND ITS EFFECT ON FINANCIAL STABILITY AND PROCYCLICAL DECISION-MAKING

ACTIONS:

Undertake a comprehensive review of why companies favour funding through debt rather than equity.

This review will include analysis of whether the taxation of companies and company equity (including SDRT) might deter long-term investment and have implications for financial stability, and whether there is any viable alternative to the current design and structure of corporate taxes. This will be commissioned by the IA and be undertaken by an independent consultancy.

REVIEW:

- Following the publication of the review the IA will consider how to implement the recommendations of the report.