Reforming culture and behaviour in the financial service industry: NY Fed Seminar, 20th October, 2016

CONTEXT

1. This is a welcome and timely opportunity to "expand the dialogue" on culture and behaviour to investors in a discussion that has until now focussed almost exclusively on the responsibility of the board and executives of the corporate entity. It should be noted at the outset that, while this discussion centres on potential investor influence on culture in banks, largely similar agency issues arise in respect of culture in other businesses and in respect of other "societal" issues such as the environment and climate change.

2. Focussing on the financial service industry, reasons for lack of investor engagement hitherto on cultural issues in investee banks prominently include:

   a) Prime responsibility for embedding and maintenance of a culture programme is necessarily for the board and executive of the company

   b) The board of the company has a clear continuing accountability to its shareholders, whereas the responsibilities of asset owners and fund managers are more varied, typically less clear-cut and commonly include the option of selling stock.

   c) As against the clear visibility of hard financial metrics, the difficulty of recognising and measuring the cultural health of an entity (save after an event of mishap or failure which gives rise to a penalty) coupled with an agency gap which impedes effective communication between fund manager and board can be a material discouragement to shareholder initiative on cultural issues

   d) Even where cultural issues have been identified, the wide dispersal of holdings limits the capability of most fund managers, independently of others, to exert meaningful influence

   e) A degree of presumption or expectation that the reach of financial regulators extends to cultural issues/deficiencies may lead to an abdication of responsibility on the part of investors.

RESPONSIBILITY AND OPPORTUNITY

3. Despite the weight of these factors, it would be altogether mistaken to conclude that investors have neither interest, responsibility nor ability to seek to exert constructive influence on culture in their investee entities. In particular post the GFC, equity capital in banking is a still scarcer resource and its providers are entitled to be more demanding as to its use:

a) There will always be shareholders for whom the objectives and business model involves or largely depends on short-term trading activity. But many holders will wish to avoid crystallising the loss that may be involved in selling. In any event, the option of exiting a major stock is less available to a manager working to an index and who is in consequence interested in the continuing performance of entities whose shares he is effectively obliged to hold.

b) While regulatory requirements call for quarterly corporate earnings reporting[1] and fund manager mandates may commonly call for (and technology permits) effectively real-time reporting on relative or absolute portfolio performance, the common and most natural time horizon for major asset owners such as pension, sovereign wealth funds and endowments is long-term. So a key relevant question is how the plethora of short-term pressures (which also include the influence of a good deal of sellside research) might be mitigated.

c) This underscores the critical importance of the cultural ingredient in the wider context of FCLT[2]: a business without resilient culture is unlikely to flourish in the long-term. Embedding good culture is not merely a "nice to do": there is now growing evidence that its absence or presence ultimately has a leveraged impact on hard financial numbers –a theme that is being given increasing weight in credit ratings and thus with increasing relevance for bond investors. Recent history reminds that the clues to corporate failure are often more apparent when taking a holistic view of corporate health rather than a narrow evaluation based solely on financial reports.

d) New cultural programmes take time to embed, which means that when cultural deficiency is identified, the need is for early remedial initiative by the board supported and, as appropriate, insistently encouraged by shareholders – which may require significant strengthening of the board or change in executive leadership. Without such change, the entity is vulnerable to cultural failure, potentially giving rise to substantial penalties of which the burden has hitherto been largely borne by shareholders.

e) Long-term investors typically dedicate substantial commitment to their own in-house culture in discharging fiduciary responsibilities to their asset owner clients, not least as a source of competitive advantage. Anything less than a complementary focus on culture in their investee companies would seem inadequate and inconsistent.

f) In the aftermath of the GFC there is an unsurprisingly increased societal interest in a financial system that is not only resilient in the sense of its reduced vulnerability to short-term instability but which is also dependably supportive of the real economy on a sustainable long-term basis. Embedding robust cultural

[1] Note that these requirements have been relaxed in the EU but quarterly reporting continues as established market practice for most entities.
[2] Focussing Capital on the Long Term

standards on a basis will be a critical ingredient in this. It is more likely to be achievable the more effective the signalling from shareholders that they share this objective.

THEMES FOR STEWARDSHIP

4. This underscores the timeliness of discussion on long-term stewardship responsibilities of major asset owners and their mandated fund managers. Given their exceptional social externalities, this has special relevance in respect of holdings in major financial institutions, the core focus here. But it plainly also has relevance for holdings in other major corporate entities.

5. Investment objectives and operating models will inevitably continue to differ. But for asset owners for whom the core time dimension is long-term, attentiveness to the following three broad themes are recommended as good stewardship practice. The focus here is on equity investors, but there is plain relevance for bond investors, especially where bonds have acquired equity-like characteristics and, in Europe, increasingly displace bank credit:

   (a) Asset owners should **communicate** to the boards of their investee companies that their objectives are to achieve sustained positive performance over the longer-term, and that they expect to be supportive of boards working to this end; and in parallel to communicate to the consultant community and to their third party fund managers that their principal focus is on benchmarking long-term performance, as far as possible undistracted by short-term company earnings and market performance gyrations. Under the same rubric of **communication**, asset owners should indicate their reciprocal expectation that their investee company boards should be ready for appropriate shareholder engagement, with input in particular from regular independent evaluation of board leadership and effectiveness.

   (b) Where asset owners are outsourcing part of their fund management, the **selection** process and award of mandates should focus on managers whose operating model and capability is closely aligned with asset owner objectives. Where these centre on sustained long-term performance, an eligible manager should be equipped with a corporate governance resource able to engage with boards of investee companies with the ability to exercise discretion on voting matters, independently of proxy voting agencies, within a framework of specific preferences indicated by the asset owner. If it is to be value-additive, such governance resource and insight should be appropriately aligned with and incorporated into the asset manager's decision-making process.

   c) The typically wide dispersal of shareholdings in banks (as in most other listed businesses) means that the ability of even larger asset owners or fund managers to engage appropriately effectively with a board will be enhanced where this can be done through **collaboration** with other holders. One approach being deployed in the UK and Australia is a survey in which a sizeable group of shareholders participate in a qualitative assessment process through submitting views on a calibrated basis that are aggregated to yield a “board confidence index”, which is then communicated confidentially to individual board chairmen. Another approach, in relation to the board of an entity where a group of fund managers have similar concerns, for example about the composition or capability of the board, is some form of collaborative initiative to be laid before the board chairman or SID. The terms for such **collective engagement** require sensitivity to regulatory and legal requirements. But practical progress is being made in this important area in the UK, and given that American asset owners and fund managers hold around a quarter of UK listed entities, their specific interest in finding ways and means for participating in such initiative is clear. All this would appear to have wider implications for public policy discussion in the US, where SEC regulation may impede effective shareholder intervention of a kind that is now being developed in the UK.

LOOKING AHEAD

6. Without progress with stewardship initiative on lines such as these, two predictable developments will be a further increase in the role of activist investors and a further switch in asset allocation away from public markets to the alternative investment space. The point is not that these are necessarily negative developments, and in some situations they may bring significant societal benefit. But they would be indicative of a material weakness in the market-based capitalist system, reflecting a view that the agency gap between asset owner and boardroom is unbridgeable. That is in my view an unfortunate and unnecessary conclusion.

David Walker