

Les Patrons Mangent Ici

A practical guide to better alignment in the financial services industry

New City Initiative

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The New City Initiative

The New City Initiative is a think tank that offers an independent, expert voice in the debate over the future of financial regulation.

Founded in 2010 by Daniel Pinto and Derek Laud, NCI counts amongst its members some of the leading independent asset management firms in the City of London and continental Europe. NCI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, an old fashioned “client-centric” approach has enabled entrepreneurial firms in the Square Mile and beyond to emerge as a growing force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

Today NCI is comprised of 42 leading independent asset management firms from the UK and continental Europe, managing approximately £300 billion and employing several thousand people.

NCI core aims:

- To serve as an independent, expert voice in the debate over financial reform.
- To restore society’s trust in the financial sector.
- To promote the values and practices of European owner-managed firms which align their interests with those of their clients.
- To raise awareness of the positive, stabilising contribution small entrepreneurial firms make to the economy and society as a whole.

Scope

As the financial services industry seeks to rebuild itself in the wake of the global financial crisis, the need to find new ways to manage risk becomes a greater part of the debate. With national governments, the European Union, and various global associations and supranational bodies all looking at additional ways to regulate the industry, this paper examines whether there is an alternative, and perhaps more effective, route to reforming the industry through the encouragement and incentivisation of behavioural change.

Better alignment of managers with their clients can reduce risk, improve performance, and rebuild trust in the financial services industry. We do not believe that this should be accomplished by additional regulation on remuneration or ownership, but rather through a process of cultural change and increased transparency. The aim of this paper is to offer practical suggestions about how investment managers can become better aligned with their clients, drawing on our experience as financial SMEs for whom this is a fundamental tenet of our businesses. We then explore how these suggestions can be applied to participants in the financial system more broadly. Finally, we offer suggestions to policymakers on how they can encourage better alignment within the financial system.

Policy Responses:	
Response 1	Support and accreditation by regulators and industry stakeholders for the establishment of a 'Code of Good Practice' for the fund management industry (to incorporate the relevant key principles discussed below).
Response 2	Deferral of income tax on remuneration fund managers are compelled to invest into their own funds, and limited deferral on voluntary co-investment in order to encourage alignment.
Response 3	Simplification of the regulations around making employees partners in financial LLPs, and encouraging employee ownership further in both companies and LLPs in line with policymakers' efforts to increase employee ownership more broadly.

Summary of key principles

1. **Co-investment with clients:** Investment managers should invest a significant portion of their investible wealth alongside and in the same products as their clients, whether these are direct investments, funds, derivatives, or structured products.
2. **Co-investment of remuneration:** Fund managers should invest a material portion of their remuneration in their funds alongside their clients.
3. **Employee ownership:** Investment managers should be encouraged to invest in the equity of their employer.
4. **Variable remuneration:** Bonuses should be assessed using performance over a meaningful timeframe.
5. **Independence:** Wealth managers must be able to select the best products for their clients, without bias either from rebate arrangements or towards in-house products.
6. **Promoting better alignment in the retail banking industry:** Better alignment should be encouraged through the devolution of responsibility to individuals who are personally incentivised to make sensible lending decisions.

The current situation

Policymakers and commentators have been slow to rediscover the importance of alignment, responsibility and partnership. These principles from the City of old were regularly portrayed as expensive, old-fashioned and unnecessary in the boom years before 2007. However after the financial crisis the terms of debate have changed for a generation. The public has seen clearly the dangers posed by banks which are ‘too big to fail’, where risk has run unchecked as a result of remuneration structures which have enabled bank employees to share handsomely in the rewards of a debt-fuelled boom, while (with several notable exceptions) avoiding the consequences of their actions when the cards were down. Likewise, those investors, large and small, who lost money in complex products peddled to them by their wealth managers and private bankers, have seen through the illusion that their trusted advisers are ‘on their side’ and sharing in the same risks to which they have been exposed. It is clear that a culture shift is essential in order to restore the relationship between clients and their advisors, and to restore the connection between decision-makers and the consequences of their decisions.

The primary reaction since the financial crisis has been to propose increased financial regulation to react to the problems that arose. However we are concerned that further increases in an already heavy regulatory burden will provide significant challenges for financial SMEs, resulting in unintended consequences such as reductions in competition, innovation, investor protection, and consumer choice, as fund managers either move domicile to exempt themselves from regulation, or become unviable in their current independent format. We believe that rather than just looking for reactive solutions, it is time for policymakers to start looking at ways to encourage and incentivise a broad cultural change within the financial services industry.

The reputation of the whole financial world has been damaged by the fallout from the financial crisis. However rather than view “the City” as the a single entity, we believe it is important for policymakers and the public to make a clear distinction between the institutions which caused the financial crisis, deploying vast quantities of their own capital in high risk lending and treasury investments (and concealing yet more in opaque off balance sheet vehicles), and those firms and institutions which did not.

As previously discussed in our inaugural policy paper “Alignment of Interests: Fixing a broken City” (October 2010), financial SMEs¹ bear no responsibility for the financial crisis, and required no bailouts by the taxpayer following the global financial crisis of 2007/08. It cannot be emphasized too strongly that financial SMEs engaged in the investment management business do not trade on their own balance sheets, and therefore present no systemic risk to our financial foundations.

Rather, financial SMEs should be actively encouraged, not only as significant employers across London and the other major cities of Europe, but also because they exemplify best practice in a number of ways. Our third policy paper, “Start Up Britain is Here in London: Why it is crucial to support financial SMEs” (November 2011), explains how financial SMEs contribute significantly to the financial services industry through their entrepreneurialism and innovation, championship of diversity, superior investment returns, and finally by setting an example of best practice in manager remuneration and alignment. This is not a small subset of the financial world; financial SMEs now employ over 350,000 people in Financial Services in the UK alone, for example.²

¹ Financial SMEs for the purpose of this paper are defined as financial institutions with fewer than 250 employees.

² “The Significance of the SME sector in the UK Financial Services Industry”, IIMAS & NCI, November 2011

For these reasons, we believe that policymakers should encourage smaller, employee-owned business in the financial services industry in the same way as they support other entrepreneurial businesses in sectors such as technology or renewable energy. The owners of these businesses are not trying to create new financial services behemoths, but rather to generate outstanding investment performance for their clients through a long-term, independent approach, and alignment of their clients' interests with their own.

We believe that the time is ripe for both policymakers and the financial services industry itself to take a long, hard look at what has gone wrong over the last decades, and to seek solutions which can reduce risk and rehabilitate the industry in the eyes of the public. The focus on co-investment of variable remuneration in ESMA guidelines on remuneration for Alternative Investment Fund Managers (AIFMs) and UCITS fund managers (under the forthcoming UCITS V regulations), comments from Bank of England Deputy Governor Paul Tucker on bankers' remuneration (reproduced below in the section on Banks), and the Kay Review's focus on the importance of incentives to maintaining trust and confidence in the process of financial intermediation, all encourage us to believe that the terms of debate are gradually shifting in favour of promoting increased alignment of managers with their clients and responsibility for their own decisions, and away from the system which enabled bankers and investors to 'get rich quick' at their clients' (and ultimately the taxpayers') expense, with little financial risk to themselves.

Principles of alignment

The New City Initiative has consistently emphasised the importance of alignment between asset managers and their investors and clients in reducing risk for investors, reducing risk to the financial system, and rebuilding trust between the industry and those whose investment, pension and insurance products it manages. In our written recommendations to the UK Independent Commission on Banking, we expressed our view that beyond the capital adequacy and ring-fencing solutions that were (and still are) being considered, the most effective method of addressing excessive risk-taking in financial institutions is an improved focus on alignment.

The concept of 'eating one's own cooking' is central to how our members operate. NCI (both in London and through NCI Europe in Paris) has as its members a large number of financial SMEs which exemplify good alignment in various different ways. Good alignment in the context of investment management can involve a wide variety of different practices and combinations of practices, but in essence it requires an advisor to act in a manner which is truly independent and entirely in the clients' best interests rather than his or her own. The core principle is always that each action taken should increase the exposure of the manager to the same risks to which his or her clients are exposed, and reduce the potential for conflicts of interest which might cause the interests of manager and client to diverge.

This means investing the client only in products in which the advisor would be happy to invest himself. It also means that advisors should be paid only by their clients and should be tied to no financial service provider (even one connected with their own employer) – a principle that the former FSA recognised in the Retail Distribution Review. Performance-based remuneration is a key part of the debate on reform of the financial services industry and one that cannot be ignored when looking at how to improve alignment. Remuneration is a challenging issue across the different facets of the investment industry, as the roles of investment selection, portfolio management, and client servicing are often not clearly defined, and vary considerably from firm to firm. Investment in the equity of the management firm is strongly encouraged, although we recognise that this is of greater benefit in financial SMEs than in larger investment management firms.

We discuss below how these principles can best be implemented in various different types of business, looking at how they can apply to the smaller investment managers, and also larger firms in the financial services space, so as to work towards achieving genuine alignment.³

Principle 1	Co-investment with clients Investment managers should invest a significant portion of their investible wealth alongside and in the same products as their clients, whether these are direct investments, funds, derivatives, or structured products.
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It is essential that fund managers invest significantly in their own funds. This is the truest form of alignment and the most feasible way to ensure that managers share in the same risks and rewards as their clients. Clearly the definition of ‘significantly’ can be debated, and we accept that a smaller proportion of a manager’s overall wealth should be invested in a fund which exhibits a higher level of risk or specificity. However it remains the case that, in general, investors should avoid investing in funds where the manager does not have a personally significant level of co-investment.

Better alignment with clients will lead to better risk management and ultimately, we are convinced, superior investment performance. While many firms have gone public, making the concept of partnership less viable (although not entirely redundant), there is no reason why fund managers from the larger investment management houses, whether public or private, should not be as well aligned with their investors at fund level as those working in financial SMEs.

We note with great interest the importance attributed to co-investment in the real estate funds sector, according to a recent survey published by the law firm Nabarro. Since the financial crisis, the level of co-investment in real estate funds by the fund manager has become a “key issue” when looking at investment opportunities. We feel that the conclusions of this survey are not unique to real estate funds and are directly relevant to investment funds more widely. Excluding two factors which are specifically relevant to a private equity style structure (a clear exit route, and low debt strategy), co-investment by the corporate manager was the most important factor for core funds, while co-investment by the corporate manager and by individual managers were the top two factors in selecting non-core value-added or opportunistic funds.⁴

The situation is somewhat different for wealth managers than for fund managers, as the former often do not have a pooled vehicle into which the managers can themselves invest, while the clients of the latter typically invest into a mutual fund which is common to all of them, thus making it possible for the manager to invest in exactly the same product as the majority of his or her clients. However it is perhaps even more important for wealth managers to co-invest fully alongside their clients as they do not have the excuse of investing in an area which may be quite specific. If a wealth manager is proposing a diversified multi-asset portfolio for a client’s entire investible wealth, then that manager should be prepared to manage a substantial proportion or all of his or her own wealth according to a very similar model (with appropriate adjustments for risk tolerance and investment horizon) and in the same component vehicles.

Co-investment is also relevant as part of the discussion around the concept of partnership. Many investment managers are structured as limited liability partnerships (‘LLPs’), and we support this as a structure which encourages better alignment. Looking at NCI’s members, only one member (a banking partnership) is structured as a traditional partnership with unlimited liability, and it could be argued that this ‘pure’ partnership structure engenders a superior form of alignment.

³ Throughout this paper we use the term ‘investment managers’ to refer to both fund managers and wealth managers (including Independent Financial Advisors, or IFAs) collectively.

⁴ ‘Funds trends survey 2011/2012 and 2010/2011’, Nabarro (<http://www.nabarro.com/Downloads/10268.pdf>)

However we consider that for investment managers, who are not risking their own capital, the form of partnership is less relevant. The element of personal liability which is so important in a banking partnership is in fact largely replicated by co-investment, which ensures that the capital of the investment manager is ‘at risk’ in the investments which are made, in a similar way to that of the partners in a banking partnership.

Principle 2	<p>Co-investment of remuneration</p> <p>Fund managers should invest a material portion of their remuneration in their funds alongside their clients.</p>
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We would like to see fund managers reinvesting a significant portion of their remuneration (and in particular the variable portion of this) into their own funds, for a meaningful period – ideally three years or greater. In some cases (for example in a start-up fund, or where the fund manager is early in his or her career and has large external financial commitments) this may be impractical, and an element of discretion should be applied by investors in assessing this factor. But in general we believe that this is highly desirable, and a more practical solution to the asymmetry of performance-related pay than the imposition of ‘clawbacks’.

This paper is not NCI’s first discussion of remuneration and the importance of remuneration being co-invested to encourage alignment. NCI has been closely involved in the formulation of remuneration policy since its inception in 2010, and contributed fully to the debate around proportionality in implementing CRD III (2010/76/EU) (“CRD III”). However the principle of proportionality is being called into question for fund managers under both the current draft Alternative Investment Fund Managers Directive (2011/61/EU) (“AIFMD”) and also the forthcoming UCITS V regulations. We cautiously welcome the direction of travel, but not the means.

We are broadly in favour of enlarging the role of national regulators to focus on investor protection as well as systemic risk, and the recognition that this can most effectively be achieved through greater alignment of managers with clients. Furthermore, we are encouraged by the proposal that the proportion of remuneration required to be paid in equity can now be paid in either equity in the management firm or units of the fund managed. We also welcome the decision by ESMA to exclude distributions of partnership profits (where it is clearly separate from remuneration) from the calculation of remuneration.

However, we are concerned about the application of ‘clawbacks’, which can be a blunt tool and are illogical for owner-managed firms where the fund manager and the owner are often one and the same. We are also concerned that the application of proportionality has been diluted, and hope that the decisions and thresholds for proportionality will be transmuted to the discretion of national regulators as with CRD III. Moreover we consider that proposals for investment of a portion of a fund manager’s remuneration into his or her own fund (or indeed the equity of the firm) have not been fully thought through; the current guidelines issued by ESMA will result in managers suffering significant income tax upfront on remuneration re-invested as well as that actually received upfront, and also crucially ignore the specific risks of the manager’s fund itself. We offer solutions to these issues in a more extensive discussion of re-investment of remuneration under Policy Response 2 below.

Finally, the concept of caps on variable remuneration causes us great concern that unintended consequences are likely to increase, rather than reduce, risks to investors both large and small. Firstly, this measure would likely lead to an increase in fixed remuneration levels, both weakening the important link between performance and reward, and also prejudicing those financial SMEs for which higher levels of fixed

remuneration may not be economically viable. Secondly, we believe that the proposal to limit bonuses to individual fund managers based on the financial performance of the firm as a whole is misguided, as not only is it unfair to penalise individual managers for the performance of their colleagues, but it may also result in struggling firms losing their 'star' managers which are their best chance of turning the firm's financial performance around. Lastly, we believe that UCITS has been a great success story (now, according to the European Fund and Asset Management Association, accounting for some 70 per cent of assets and 65 per cent of funds managed by the European investment fund industry) and has materially increased the levels of protection for investors across Europe. However we are worried that measures such as caps on variable remuneration and fund performance fees will drive fund managers away from the UCITS framework and by doing so reduce both choice and protection for consumers.

Principle 3	Employee ownership Investment managers should be encouraged to invest in the equity of their employer.
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This is a less direct form of alignment than investing fund managers' own capital alongside that of their clients. However, if the investment management firm is sufficiently focused, sharing in the ownership of the firm brings key benefits, encouraging employees to behave less as individual 'contractors' and more like owners of the business. This should have the effect of reducing turnover of personnel within a firm, increasing employee motivation, and fostering a sense of responsibility with regard to the firm's activities which improves corporate responsibility.

We welcome the shift in favour of employee ownership among policymakers in the UK, as illustrated by the Nuttall Review of Employee Ownership (July 2012), and the government's positive response to this in the 2012 Autumn Statement (December 2012). We agree with Nuttall that employee ownership brings substantial economic benefits, and our own experience through the recent economic downturn supports the findings of the Cass Business School, that employee-owned companies demonstrate a greater degree of resilience during such periods of economic weakness.⁵

Our own experience as financial SMEs also supports Nuttall's observation that the legal, tax and other regulatory complexities of employee ownership often present a barrier to the adoption of broad employee ownership; a number of our members have been discouraged from expanding employee ownership within the LLP structure they use and some have actually felt compelled to reduce the number of employees with an ownership interest.

If employee ownership is to increase, these complexities need to be minimised together with the provision by governments of clear guidelines and template shareholder agreements for companies to use. In the 2012 Autumn Statement the UK Chancellor of the Exchequer confirmed the introduction of a new employee shareholder employment status with effect from April 2013. Under the proposed share ownership scheme individuals may receive capital gains tax (CGT) exempt shares in their employer worth at least £2,000 and a maximum of £50,000, in exchange for agreeing to become employee shareholders (and with no other consideration permitted). Employee shareholders will not have certain employment protections and rights normally enjoyed by employees.

While we welcome these developments, we also encourage policymakers to include non-corporate structures such as LLPs within such a scheme, as the economic benefits should be equally worthwhile. Finally, we hope that as the scheme proves its worth, policymakers will consider encouraging employee ownership further by calculating the tax- and NICs-free threshold as a percentage of employee remuneration rather than an absolute figure.

⁵ "Worldwide Investment Fund Assets and Flows", EFAMA, 5 April 2013 (p. 10)

⁶ "Sharing Success: The Nuttall Review of Employee Ownership", July 2012 (p. 52)

<http://www.bis.gov.uk/assets/BISCore/business-law/docs/S/12-933-sharing-success-nuttall-review-employee-ownership.pdf>

Principle 4	Variable remuneration Bonuses should be assessed using performance over a meaningful timeframe.
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We preface this discussion with the caveat that if the investment manager already has a very significant level of co-investment, it is less important that variable remuneration is assessed over a longer timeframe as the manager is already very closely aligned with his or her clients. Nonetheless, we consider it preferable for performance-related remuneration to be assessed over a period longer than the typical one year.

There are two factors at play here. First, it is much more difficult to sustain good performance over three or five year periods, for example, than for a one year period. According to research by Allan Roth of Wealth Logic, the chance of a long-only active fund manager outperforming an index fund (net of fees) is 42 per cent over one year, falling to 30 per cent over five years and just 23 per cent over ten years: in other words, over the course of a decade, more than three quarters of active fund managers may be expected to underperform their benchmark index. When a portfolio of ten funds is considered, the chance that the active portfolio will outperform the index portfolio falls from 25 per cent over one year to just 9 per cent over five years and 6 per cent over ten years. Given the difficulties of sustaining performance over longer timeframes, it seems illogical for managers to be rewarded for their performance over relatively insignificant one year periods.

Second, performance-related remuneration over too short a timeframe can encourage managers to take excessive risks to generate a substantial pay-out in one year, with the knowledge that (unless, as discussed above, they are heavily invested in the fund themselves) they will not share in the downside if the fund then gives back this performance in the following calendar year.

With regard to the charging of performance fees at fund level, we look forward to working with policymakers to devise sensible guidelines which increase alignment (incorporating factors such as high water marks, ratchets and appropriate time periods) while minimising the less desirable aspects of performance fees as outlined above. These guidelines will form a key part of our proposed Code of Good Practice for fund managers, as discussed below.

Principle 5	Independence Wealth managers must be able to select the best products for their clients, without bias either from rebate arrangements or towards in-house products.
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Firstly, wealth managers and IFAs should be paid only by their clients. This issue has been largely addressed in the UK after the Retail Distribution Review. However for wealth managers and other financial advisors outside the UK who receive any kind of payment from fund managers, it is essential that this payment is rebated directly to clients in order to avoid a conflict of interest whereby clients are invested not in the funds which are judged the best or most suitable, but rather in those which pay the greatest retrocessions to wealth managers.

This principle also discourages the practice of ‘churning’ clients’ fund holdings, whereby advisors are incentivised to turn over a portion of their clients’ portfolios on a regular basis in order to receive upfront fees from the fund manager. Needless to say we consider this to be wholly inappropriate behaviour as such portfolio activity is invariably prejudicial to investment performance over the long term through higher underlying costs and often poor timing.

⁷ *How a Second Grader Beats Wall Street*, Allan Roth, Wiley 2009

Secondly, wealth managers must be able to select the best products for clients from the full universe of available appropriate investments. A key aspect of alignment with clients is that if the wealth management firm, or a parent or affiliated company, does have its own investment products, these products should be evaluated by the wealth manager at arm's length and on the same terms as all other similar products in the marketplace. All too often supposedly independent wealth managers invest a large proportion of their clients' wealth in 'in-house' products. Even taking into account fee differentials, it is extremely unlikely for any one investment house to have the best or most suitable products across asset classes that together comprise even one quarter of their clients' portfolios.

Private Equity Structures

We do not propose to address the private equity and real estate industries in detail in this paper, partly because the private equity industry is increasingly adopting the Institutional Limited Partners Association ('ILPA') Private Equity Principles on alignment, and partly because this is an almost entirely institutional arena of investment.

Nonetheless, we are encouraged both by the increase in 'carried interest' (or co-investment) by managers from historic levels of as little as 1 per cent, and by the on-going improvement in deal terms in favour of the investor rather than the manager. One key example of this is the shift towards charging performance fees on pooled returns rather than on a deal-by-deal basis (which has a similar effect to the lengthening of the performance appraisal period for fund managers).

We are also impressed by the concept of voluntary codes of practice as introduced by industry bodies within these sectors, such as the ILPA Private Equity Principles and the Guidelines published by the European Association for Investors in Non-Listed Real Estate Vehicles ("INREV"), and describe below NCI's intention to launch a corresponding code of conduct for the fund management industry. Critics may argue that such voluntary codes lack the teeth necessary to make an impact, and that managers will not adopt the code unless they are forced to. However, the success of the INREV Guidelines shows that there is a genuine interest in reforming financial services, and that voluntary conduct codes can work. INREV's 2011 report shows that after three years the industry has settled into strong levels of adoption, with 94 per cent of non-listed real estate funds complying with at least 50 per cent of the annual reporting guidelines.

INREV: Adoption of Best Practice Reporting Guidelines by non-listed real estate funds for 2011⁸



Banks

Big banks should learn from the financial SME sector. It is not a coincidence that no private banking partnership required 'bailing out' by its national government during the global financial crisis. In this case we recognise that regulatory input may be required, such is the extent of the cultural shift necessary in the industry (and the systemic risk if it gets it wrong). We propose that by following various models of good practice exhibited by the independent financial SME sector, risk can be reduced not only in the systemic sense but also to the banks and their shareholders themselves. This would have the effect both of creating a safer financial system in the UK and Europe, and also of reducing the likelihood of periodic collapses in the value of investors' capital invested in bank equity.

We have one bank as a member of NCI, the last remaining of the former banking partnerships in the City of London. Europe's large banking partnerships are almost exclusively located in Switzerland. The example of the Swiss banks during the financial crisis of 2007/08 provides a graphic illustration of the benefits of alignment and responsibility in navigating a period of intense economic turbulence. UBS, owned by a widely diversified public shareholder base, required an almost \$60 billion rescue from the Swiss government (including the provision of \$6 billion of capital for a 9 per cent stake in the bank) in October 2008, and Credit Suisse was forced by the Swiss government to raise \$8.75 billion from a consortium led by the Qatar Investment Authority. However the major privately-owned Swiss banks, such as Lombard Odier and Pictet, required no such financial assistance. While information on the underlying performance of these private banks is not published, it seems that the unlimited liability borne by the partners of these institutions gave them a very strong incentive to avoid excessive leverage and reckless investment practices.

How, then, can the experience of the financial SMEs of NCI inform banking practices and culture in Europe, given that a return of all banks to a partnership structure is clearly unfeasible? In fact, we believe that NCI is in a unique position to comment on the banking system from an industry perspective. As we have previously discussed in the media and elsewhere, we are supportive of the Vickers Inquiry's recommendation for a form of ring-fencing of banks' retail and commercial banking operations, and for higher capital requirements (albeit recognising that right now may not be the appropriate time for full implementation of the latter measure). We are also supportive of compulsory debt-equity swap ('bail-in') arrangements, whereby bank bondholders will be forced to 'bail-in' banks in trouble, reducing the 'bail-out' burden on the taxpayer.

However we believe that these measures are insufficient, as they focus solely on measures to mitigate the effects of excessive risk-taking by bankers, when we should equally importantly be concentrating on how best to limit this impulse at source. In our opinion the solution to this lies in greater alignment of bank employees with the outcomes of their decisions, and we strongly agree with the outgoing Bank of England Deputy Governor Paul Tucker that pay structures for 'desk level' bankers need to be reviewed in order to "make it less easy to get rich quick irrespective of the quality of business transacted".⁹

⁹ "Review of Reporting Best Practice", INREV 2012

Principle 6**Promoting better alignment in the retail banking industry**

Better alignment should be encouraged through the devolution of responsibility to individuals who are personally incentivised to make sensible lending decisions.

The credit crunch in the UK was not caused solely by the ‘casino banks’, as common parlance now has them. Arguably the foundation of the crisis lay in risky lending practices by retail banks (facilitated, of course, by excessively low interest rates set by the Bank of England). No one could accuse Northern Rock or Bradford & Bingley of being ‘investment banks’ of the type from which the Vickers report recommends depositors should be shielded. In fact, the greatest dangers to these retail banks were not investment bankers or proprietary traders, but their own lending practices.

In short, we are convinced that the restoration of trust and sustainability to banking is dependent upon the devolution of responsibility to bank employees who are properly incentivised to make sensible, well-informed decisions, through proper alignment with the outcomes of their decisions. The rapid expansion of Handelsbanken in the UK (with over 150 branches across the country) has shown that there exists a strong demand for banks where decision-making rests with the people who are best placed to make those decisions – those who deal directly with customers in the bank’s branches.

The critical factor of alignment with the economics of those decisions can be achieved either by a model which rewards sensible lending over volume of lending at any cost, or by one which looks at longer-term performance metrics (ideally, over a period of several years), and which may include ‘clawback’ provisions for when decisions prove (also over an appropriate timeframe) to have gone awry. Without responsibility and alignment, those who market banking products have no incentive other than to maximise their volume. What is absolutely unacceptable is to continue to incentivise risky lending or selling practices through an absence of responsibility and a lack of appropriate alignment with the outcome of those decisions.

We support the progress that has already been made by regulators and banks in this area, and we hope that they continue to take it further. Clear reforms have been put in place under the PRA Remuneration Code to require that at least 40 per cent of bonuses for “Code Staff”¹⁰ should be deferred for between three and five years.¹¹ However, how banks deal with the deferred payments will be the key indicator in showing whether banks are truly reforming their culture. The deferred element of the bonus allows banks to reduce or even cancel a bonus if it transpires that an employee took reckless risks or behaved illegally. In theory, such powers should remove the asymmetry that existed previously whereby bankers were rewarded for their success but not penalised for their failures. However, only time will tell as to whether banks will use the reformed remuneration structures to penalise employees for high risk behaviour that is in the interest neither of the banks nor their clients.

Equally, we are concerned about the implications of the EU’s decision to introduce a cap on variable remuneration for Code Staff earning in excess of €500,000 per annum, under the Capital Requirements Directive IV. The likely response by the banking industry to this bonus cap is to increase fixed salaries; a poll of more than 150 human resources employees conducted by professional services firm Towers Watson in May 2013 found that only 7 per cent thought the EU rules would be successful in reducing pay across the financial services industry, while 53 per cent believed that they would actually increase pay.¹² Large fixed salaries paid to staff regardless of performance, which are not subject to clawback rules, significantly reduce banks’ ability to incentivise long term decision-making over focussing on short term gains.

⁹ “Paul Tucker, British Bankers’ Association conference, 17 October 2012

¹⁰ “Code Staff” includes all senior management, risk takers like traders, and those involved in control functions (such as audit, risk or compliance)

¹¹ PRA Handbook SYSC 19A.3.49

¹² Bloomberg news, 11 June 2013 (<http://www.bloomberg.com/news/2013-06-10/most-banks-expect-salary-increases-to-offset-eu-bonus-cap.html>)

The policy response

As discussed above, we believe that the policy response should be dictated by the level of systematic risk posed by the type of institution. Large banking institutions are a clear case where we consider that regulation is necessary to protect the financial systems of the UK and the Eurozone from a recurrence of the poor lending practices and malinvestment which contributed to the recent financial crisis.

However we do not believe that additional regulation is appropriate for financial SMEs and other such firms which pose no systemic risk, and which are (through co-investment or the partnership model) already well aligned with their clients. What we would prefer to see in these cases is legislation which facilitates financial firms in observing the principles outlined above, and encourages them to limit risk through co-investment and alignment.

Response 1	Support and accreditation by regulators and industry stakeholders for the establishment of a 'Code of Good Practice' for the fund management industry
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As discussed above, we intend to create and promote a Code of Good Practice for the fund management industry, inspired by the ILPA and INREV codes and incorporating many of the key principles discussed in this paper. This should encourage fund managers to be aware of the best principles of alignment and transparency, and require them to explain their position if they choose not to adopt them. We intend that the Code should become a 'kite mark' of quality for fund management firms of all sizes, and hope that it will be widely adopted, improving standards of alignment – and thereby reducing risk and improving returns – across the industry.

Code of Good Practice - Key Principles: <ul style="list-style-type: none">• Maintain meaningful levels of co-investment with clients• Clear policies to encourage reinvestment of remuneration• Incentivisation of employees through employee ownership• Independent service to clients• Fee structures which encourage alignment• Transparency of fund management costs

The Code will cover a number of areas in which managers are able to demonstrate that they are both acting in the best interests of their clients, and sharing in the same risks. The extent of co-investment is clearly a key factor here, both in absolute terms and as a proportion of fixed and variable remuneration.

The Code will also incorporate guidelines on fund management charges and transparency of total fund expenses, an area in which the divergence in the interests of the manager and the client needs to be mitigated. These will include recommendations on the calculation of performance fees so that they best align the interests of the client and the fund manager, taking into account factors such as suitable time periods for the assessment of performance, high water marks, ratchets, and clawback arrangements. Finally, the Code will set out more general objectives for the fund management industry, to promote independence and transparency in all activities that are undertaken.

We would like to design the Code in collaboration with European regulators, and for the finished Code to be accredited by regulators and other relevant policymakers, together with a wide variety of industry stakeholders. This should provide credibility to the guidelines, and may prove useful to policymakers in assessing systemic risk with regard to proportionality, for example.

Response 2	Deferral of income tax on remuneration fund managers are compelled to invest into their own funds, and limited deferral on voluntary co-investment in order to encourage alignment.
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If fund managers are compelled under a regulatory programme such as AIFMD, or a future iteration of UCITS, to invest a portion of their remuneration into the funds they manage, they are liable to pay income tax on that remuneration at the time at which it is awarded, rather than the time at which the cash is actually received by them. This means that these individuals end up paying upfront a far higher rate of income tax on cash received. Furthermore, in the case of limited liability partnerships, should the claw-back provisions proposed in the draft UCITS legislation become law, tax would be paid on contingent income which might be subsequently clawed back. We do not believe that managers should be penalised for mandated co-investment, and consequently propose that in this instance the income tax liability on managers' mandated investments directly into their own funds should be deferred for as long as the investment is mandated to last.

We do not propose deferral of the absolute income tax liability, as this would in effect be forcing managers to gear up their exposure to their own funds, reducing stability rather than improving it. Rather, we suggest that the prevailing income tax rate at the time of deferral is applied to the amount when the investment is realised.

We should add that while we naturally agree in principle with the concept of managers investing a proportion of their remuneration into their own funds, we feel that setting a regulatory minimum level of 50 per cent is excessive. Not only does it ignore the personal situation of the fund manager, and their existing level of co-investment in their fund; it also takes no account of the level of risk or specificity of the fund itself. While it may be appropriate for a manager to reinvest a large proportion of his or her remuneration in a balanced multi-asset fund, this is unlikely to be the case with regard to a fund investing in a single sector or an individual emerging market, for example. We believe therefore either that regulations on reinvestment of remuneration should take into account the type of fund being managed, or that the absolute proportion that managers are compelled to reinvest should be reduced, with managers encouraged to invest more if appropriate to the fund and their personal situation.

Consequently, we would like to explore with policymakers the idea of encouraging managers (especially those managing small funds providing limited remuneration), and ideally also their analysts, to reinvest their remuneration alongside their clients by offering limited deferral of income tax on voluntary co-investments up to a set amount, alongside a smaller mandated portion as discussed above. One option could be that this should be equivalent to the £50,000 CGT-free allowance for investment in employers proposed in the UK Chancellor's 2012 Autumn Statement, given that we see an equivalent or superior alignment benefit from co-investment. A second option would be to set this as a proportion of fund managers' remuneration, with an absolute upper limit. A time limit could be set of perhaps five years, at which point the income tax relating to the original investment would become payable, to prevent managers deferring their income tax liability on the invested capital indefinitely.

The limit on this enhanced voluntary reinvestment would be set low enough to prevent this becoming simply a tax deferral scheme for wealthy fund managers, but high enough to make a meaningful difference to those who, perhaps as a result of their youth or limited assets under management, might otherwise struggle to make a personally meaningful co-investment in their fund. We believe that the principle of actively encouraging co-investment is as important here as the actual amount permitted.

Response 3	Simplification of the regulations around making employees partners in LLPs, and encouraging employee ownership further in both companies and LLPs in line with policymakers' efforts to increase employee ownership more broadly.
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Many of our members are structured as limited liability partnerships, and have noted that their desire to expand the partnership to more junior employees has been frustrated by regulatory challenges. These include the supposition that partners are being added in order to avoid National Insurance Contributions, with the Inland Revenue therefore disallowing large numbers of small equity participants being added to an LLP. We would like policymakers to back up their rhetoric on employee ownership by reforming the Limited Liability Partnerships Act 2000 to enable firms to enlarge their partnerships to include all relevant employees, as they are beginning to do with limited companies.

More broadly, we welcome proposals to encourage shareholdings in employers, whether large and small, and hope that as the merits of this become apparent, policymakers will consider encouraging employee ownership further by calculating the tax- and NICs-free threshold as a percentage of employee remuneration rather than an absolute figure, as discussed above.

Conclusion

The financial services industry is a critical component of the European economy, from the global financial hubs of London, Paris and Frankfurt, to the fund management centres of Luxembourg and Dublin, and many other cities besides. In these economically challenging times it is in everybody's interest for it to flourish. Market practitioners and policymakers must work together in order to achieve this in a way which encourages competition, excellence and innovation, while at the same time protecting investors and the financial system as a whole from the excessive risks introduced in the years before the recent global financial crisis.

We are convinced that the key to achieving this is better alignment with clients across the industry – an area in which financial SMEs have led the way. NCI and our members look forward to continuing our work on this topic within the industry and with policymakers across Europe, and we hope that this paper will provide a useful step in that direction.

NCI Members

21st Century Capital	La Financière Responsable
ACER Finance	Mandarine Gestion
Beaubridge LLP	Massena Partners
C.Hoare & Co.	Mayfair Capital Investment Management Ltd
Carmignac Gestion	Moneta Asset Management
Cerno Capital Partners LLP	Montpensier Finance
Church House Investments Ltd	Neptune Investment Management
Comgest S.A.	Oldfield Partners LLP
Convictions Asset Management	Orion Capital Managers
Dalton Strategic Partnership LLP	Sand Aire Limited
Egerton Capital Limited	Senhouse Capital
Financiere De L'Echiquier	Shore Capital Limited
Findlay Park Partners LLP	Sloane Robinson LLP
Fleming Family & Partners Limited	Société Parisienne de Gestion
Focus Financial Partners, LLC	Somerset Capital Management LLP
FOURPOINTS Investment Managers	Stanhope Capital LLP
Fundsmith LLP	Stonehage Limited
Hutchinson Lilley Asset Management LLP	Sycamore Asset Management
Independent Franchise Partners LLP	Troy Asset Management Limited
Kennox Asset Management Limited	Veritas Asset Management (UK) Limited
Killik & Co	Vestra Wealth LLP

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