City and industry

Mr D A Walker, an Executive Director of the Bank, comments[1] on some aspects of the relationship between the City and industry, and in particular on how far the financial structure supports long-term development. In the context of the concern felt by many companies about the stability of their shareholder structure, he stresses the need for company boards to devote time and effort to fostering relations with their major institutional shareholders.

Mr Walker goes on to examine the proposition that discretionary managers of pension funds do not focus adequately on the long term, and argues that there can be a proper role for company boards in influencing the overall risk strategy of their pension funds by seeking to ensure that the trustees are not needlessly or inappropriately risk-averse.

You will be relieved to know that I do not propose to say much about Big Bang, of which more than enough has already been heard. Current changes in the City bring benefit for industry through making the capital market more efficient and liquid, but I want to concentrate on how far our financial structure supports long-term development. I regret the polarisation between City and industry often found in discussion on this subject.

Relationships between finance and industry are complex, and to say that there are no easy solutions to problems that arise is neither to duck the issue nor to be complacent. It is just realistic. Equally, whatever attraction some have seen in the past in other systems such as the universal banks in Germany, we have to work with the capital-market-based system that we have in this country and, if we are not satisfied with it, make it work better.

The readiness of banks to lend on a term basis and the buoyancy of the equity market have shifted attention away from problems of raising capital to the stability of subsequent relationships. But the factors that have improved access to funding for the average company may also be weakening longer-term links. Being the beneficiaries of intensified competition among the banks is obviously attractive in the short term, but there is no doubt that dealing with financing problems when the going gets rough is much more difficult for a company with a wide array of banks. Sight should not be lost of the long-term benefit of an established relationship with a lead bank, but the very intensity of competition among the banks means that initiative here has to come from companies themselves.

Moving from debt to equity, I would differentiate between institutional capitalism and what might be termed pro-active or, in some cases, speculative capitalism. The emergence of pro-active capital, benign enough at the venture capital end, has put boardroom nerves on edge because the scale of resources now available to support acquisitions means that few British companies are beyond a determined bidder's reach.

But despite the great gains in efficiency that have been achieved across the board in British industry, we should not disregard those that have been produced by takeover in some situations and spurred by apprehension of it in others. And companies may not be reasonable in expecting their shareholders to back them in the long term where they are failing to perform in the short term. Mergers policy is relevant to the way in which boards perceive their vulnerability, but I would not subscribe to a view that an adaptation of mergers policy would, by some stroke of the government's pen, cure the tendency of many boards to focus on the short term.

I turn now to relationships between boards and their shareholders. The point is obvious enough that a major investor cannot take a mature view about the future of a company unless he has some first-hand knowledge of the quality of the board. In many cases, contact between major shareholder and board is good, providing assurance on both sides. But it is hardly surprising that, in others, institutional investors are diffident about committing substantial time and effort to contact where there is little positive response from the board. Where a relationship of understanding and trust has not been established, the board should expect that shareholdings will be more readily disposed of in the event of a bid than might otherwise be the case. Equally, it is very unsatisfactory for a board to labour under the impression that major shareholders would not support long-term projects when the matter has not been discussed with them.

I am not allocating beams and motes between the eyes of investors and boards. It plainly takes two to tango, and both boards and their main proprietors need to work at relationships just as companies need to and do work at those with their suppliers, their customers and their

(1) In a speech at the CBI Annual Conference at Bournemouth, on 11 November.

workforce. What is abundantly clear is that it is far too late to leave the establishment of satisfactory relationships with the proprietors to the time when a bid comes along.

Boards cannot normally relate on a bilateral basis with smaller shareholders, but opportunities may often be missed for establishing a wider basis for investor confidence. Let me give two examples, both of which relate to disclosure.

First, few companies seem ready to quantify how much they are committing to innovation to ensure their future competitiveness. There are problems of definition and confidentiality, but it is hard to believe that these are insurmountable. If boards want their shareholders to support them in committing resources to the long term, perhaps depressing current performance on the way, it seems only reasonable that they should indicate how much is being committed, in what direction, and what the payback period is likely to be.

Second, although more companies are now ready to set out the age, roles, experience and qualification of their directors, extension of this practice would surely boost investor confidence where boards are of high quality and well-composed? If it is thought that disclosure of such detail would do nothing for investor confidence or indeed weaken it, is that not a message in itself?

The proposition is now familiar that discretionary investment managers of pension funds do not focus adequately on the long term. This is oversimplified, and blame is not necessarily being laid at the right door. Discretionary managers are agents of fund trustees and, while they will concentrate on short-term gains if that is what they are instructed to do, different instructions can of course be given.

There is the proper and essential concern not to interfere in the investment decisions of a pension fund in a way that puts the interests of the beneficiaries in any way at risk. In particular, boards should not seek to influence their pension fund trustees to undertake investment in their own shares and debt instruments or in property leased to the company.

Yet relationships between the trustees and the company are unavoidable. There is obvious reliance on the company when topping-up is needed, and it is accepted that the company may be entitled to a contribution holiday where there is an actuarial surplus. The question to be addressed is the nature of the relationship between pension fund and company between the extreme situations of over or under-funding.

Perhaps the most important strategic question for a pension fund is the degree of risk aversion judged to be appropriate. The choice of a risk-averse strategy, with a lower proportion of equities and of risk holdings such as venture capital, is likely to imply a lower expected rate of return and, for any given level of benefits, may require a higher level of employer contributions. Conversely, a higher risk, higher expected return strategy could entail lower employer contributions, but would make a need for occasional topping-up or contribution holidays rather more likely.

My point is that there is no universally correct or prudent degree of risk-aversion for the trustees of a pension fund. Where the company appears to have an assured future, and should be able to make topping-up payments if required, a somewhat higher risk investment strategy would seem justified than where there is less confidence about the future of the company. Other factors are also relevant: for example, bigger portfolios may be better able to absorb risks than smaller ones. In practice, some pension funds do pursue different risk objectives within the same overall portfolio in the sense that there is, for example, a division between that part of the portfolio which is actively traded in the market and the much larger core element which is not actively managed. But, it is very important that the balance among different possible risk strategies should be determined by the trustees in a considered and deliberate way.

All this prompts two related suggestions. First, while I stress that I am not suggesting that boards should seek to influence individual investment decisions, they should not feel inhibited about engaging in dialogue with their pension fund trustees as part of the process by which the trustees arrive at an appropriate risk strategy. Second, boards should urge trustees to be clear in their policy instructions to the investment management team and, I suggest, trustees might be urged to satisfy themselves that discretionary investment managers are not displaced solely by reference to their short-term performance if they are adhering to the risk strategy that has been laid down.

It seems inconsistent for industrialists to be reproachful of the decisions of fund managers if they are not ready to exert the influence on overall risk strategy that is in some degree properly theirs. This is to try to ensure that the trustees are not needlessly or inappropriately risk-averse in a way that fails to maximise the performance of the fund and could cause unnecessary cost to the company. Major pension funds are among the largest institutional holders of equity and many of them are the pension funds of CBI member companies. It would be easier for individual boards and pension fund trustees to re-examine these difficult issues if there were a tide of opinion in which others were doing the same. There is a task of education here in which the CBI itself could play a major role.

Summing up, I acknowledge that recent developments in the City have as much to do with ensuring that UK financial institutions and markets are competitive on a global scale as with the immediate needs of British industry. But we cannot afford to take a Little Englander view of all this, and British industry would certainly not be better served by a weaker securities industry.

I acknowledge also the concern of many boards which turns on some sort of insecurity about the stability of their shareholding structure. But part of this problem is in the eye of the beholder, and perceptions of institutional attitudes may not coincide with the reality that emerges when efforts are made to establish good relationships. Both boards and major shareholders have roles to play in this that are as important as each of the blades of a pair of scissors in ensuring a proper cut.

Last of all, there is the need to be realistic and rigorous. Some boards appear to want institutional investment managers to be directed but want to be left wholly undirected themselves, as well as freer of outside threat from possible bidders. Yet an environment in which constraints were applied to the investment decisions of institutions would probably also be one in which the freedom of boards to determine and implement their own strategies was also constrained. In preference to this, we should surely all seek to make the liberal and market-based system that we have, despite its flaws, work better.