THE PURPOSEFUL CORPORATION, AND THE ROLE OF THE FINANCE INDUSTRY

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ABSTRACT

The finance industry—banks, insurers fund managers and the rest—play a pivotal role in our economy. In particular they have a profound influence on the behaviour of our corporations and the individuals that serve them. To provide its services, the finance industry has considerable powers in corporate governance. So, if we are to reconceptualise the purpose of the corporation, this paper argues that we also need to do the same for the role of the finance industry. The paper begins with a review of the limited literature around "the purpose of the finance industry". It then poses the question about that purpose should be, whether its current practices are adequate, and how this affects corporate behaviour. We will argue that if the finance industry itself were more purposeful, that would in itself help to promote purposeful companies. Finally, the paper makes a series of recommendations on how to create a model of change within the industry to support purposeful outcomes.

Keywords: Finance, purpose, trust, purpose of finance,

INTRODUCTION

This paper was commissioned as part of the Future of the Corporation work stream at the British Academy.[1] The programme examines the need to reconceptualise the purpose of the corporation around three connected principles: well defined purposes, a commitment to trustworthiness and an enabling culture.[2] By doing this, corporations can continue their contribution to the development and prosperity of society. The central premise of this paper is that to create more purposeful companies, a finance industry is needed which supports their creation.

The influence that the finance industry has is huge. Companies require finance to survive. To fund the development of new and existing activities. To provide the system in which transactions are completed. Here finance is the ‘enabler’ to the economic functions of the corporation. Finance also plays a role in ‘shaping’ the behaviour of the corporation. The powers given to shareholders can have a profound influence on how companies behave. Shareholders approve the board, auditors and incentives given to directors, and hence influence the overall strategic direction of the firm, its activities and business models, and hence its purpose.

Just as we reconceptualise the purpose of the corporation, we need to do the same for finance. This paper begins with the same critique as the Future of the Corporation. That is that we need to pose questions about the purpose of the finance industry because we cannot trust that market forces alone will guide the industry to its desired destination. We will argue that if the finance industry itself were more purposeful, that would in itself help to promote purposeful companies. In doing so, it would support the recommendations of the Policy Paper, in particular principle 7 as set out below.

> **Corporate financing should be of a form and duration that allows companies to fund more engaged and long term investment in their purposes.**

The central aim of this paper is to examine the evidence for the argument we have set out above. To do so, we will structure the paper as follows. First, we will define the functions of

[1] British Academy, (2018), Reforming Business for the 21st Century
[2] British Academy, (2019), Future of the Corporation Research Summaries

the finance industry. Second, we will present our review of the literature into the purpose of finance to provide a context to the arguments being made. Third, we will explore who the industry is there to serve and in particular its role in providing funds to companies and its use of the powers accorded to it to provide those funds. Fourth, the paper will set out what a purposeful finance industry might look like and how far the current industry is from the one we seek. To do this, we will examine how the institutions of finance provide funds and exercise stewardship. We will look at whether the shift towards Fintech will provide solutions. Fifth, we will recommend reforms which will make the finance industry more purposeful. Finally, we will discuss how this underpins the principles laid out by the Future of the Corporation, and suggest the next steps for this work.

1. WHAT IS THE PURPOSE OF THE FINANCE INDUSTRY?

"What is the purpose of the finance industry?" For other industries we are able to address this question in a straightforward manner. For instance, the motor industry builds machines which transport us from A to B swiftly, efficiently, conveniently, safely and in comfort, without hurting others. We measure its performance by its ability to build better, more efficient cars year-by-year. We might also say that in the future, it will continue to have this purpose, fulfilling it better through technological advances such as electric and driverless cars. Whether an engine uses petrol or a battery, the core purpose of the industry remains the same, with electric cars fulfilling the function in a way which minimises emissions. Other examples abound, from the healthcare industry which serves the purpose of curing the sick, to the hospitality industry which serves the accommodation of guests, and so on. Reflection might lead us to conclude that we know the purpose of most industries. Doubtless there can be some debate about precise goals, and how they are best measured. But the overall purpose of industries is usually clear, providing a metric against which success can be measured.

However in our experience, and in subsequent research which we will discuss, the evidence suggests that if you pose this question of the finance industry, you will likely be given a range of responses. Those cynical of the industry will say it's for the purpose of paying large salaries, their argument fuelled by media stories focusing on remuneration in the sector. The majority of people may tell you they just hadn't asked the question about what finance was for. And since they hadn't asked the question, they hadn't answered it either.

Since 2017, we have asked this question to a diverse range of audiences, (Further details are given in Appendix One) from practitioners in financial institutions, to politicians, to academics, to perhaps the most important stakeholders, the customers the finance industry serves.[3] It is clear that there is consensus among them that the purpose of finance is a topic worthy of debate. There is also a consensus that it would be useful to define the purpose of finance. And it is also clear to us that it is a question that few have yet answered.

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[3] Pitt-Watson, D. and Mann, H. (2017). *The Purpose of Finance Why Finance Matters: Building an industry that serves its customers and society*. London: Pensions insurance corporation.

So why do we struggle when we are asked about the purpose of finance? Is it that we haven't given the subject enough thought? Is the answer too complex, or is it that we may uncover a gap between the purpose of finance and current reality? History shows that, similar to the corporation, many of the early institutions of finance were clear about the purpose of their activity and what they were providing to their customers. Yet, the evidence we have collated finds that today's institutions and those who work in them are unclear of what the purpose is. For us to develop our argument that creating purposeful corporations requires a purposeful finance industry, we set out our thinking around what the purpose of finance might look like.

Let us firstly draw on our current thinking as to the functions of the finance industry. These draw on the history of the finance industry – the first services provided by banks, for example – and by observing the services finance is beginning to provide in the world's emerging economies. We see four essential functions.

The first is the safekeeping of assets. We sometimes take for granted that we have institutions like banks which we can give our money to, and who will keep it safe. That is an essential service, and it is one that was unavailable to most people throughout history and remains so today for many people in many countries. Within the UK, recent estimates suggest that as many as two million adults still do not have a bank account, relying exclusively on cash for their daily transactions.[4] And it is not only banks we rely on to keep our money safe. We also expect institutions such as pension and investment funds to hold our financial assets and act as custodians, albeit on different terms from a bank.

The second function follows from the first: It is to provide an effective payment system. Again, this is a service that we take for granted in the developed world. Yet without it, modern commerce could not survive. We can see its value by looking at situations where the service has been lacking. In Kenya today, migrant workers can transfer their funds back to their families using their mobile phones, through which they also receive their salaries. In the past, this process involved guards taking cash for their salaries, and then a complex process for getting the monies back to their respective villages[5].

[4] Financial Inclusion Commission (2015) Improving the financial health of the nation.
[5] Hartley, A. (2012). Pay and Go: Africa's money mobile revolution. *Montrose journal,* [online] Winter 12. Available at: http://www.montroseassociates.biz/article.asp?aid=75

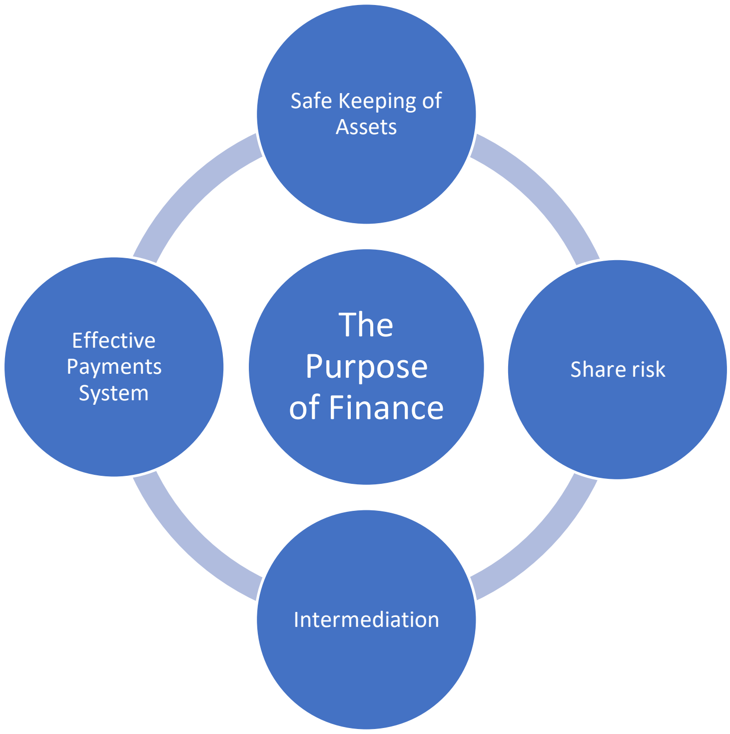
The third function of the finance industry is its ability to allow us to share risk; to allow us to buy life, car or house insurance, so that if disaster strikes, we have something in compensation. To allow us to have a pension that will last us until the day we die. Business also benefits from risk sharing, for example insuring factories or ships at sea. As a result, we can avoid many of the worst consequences of life's catastrophes.

The fourth, and perhaps the most important function provided by the finance industry is that of intermediation: matching users and suppliers of money. Put simply, intermediation is about how we "take money from point A where it is, to point B where it is needed"[6]. This process is of enormous value. At its most simple, it can be combining savings deposits and helping individuals buy homes or businesses buy assets. It allows economies to grow. It allows for social mobility. Before modern banks, assets were simply passed from generation to generation. What social mobility there was amounted to a process of everyone raising themselves by their bootstraps. So intermediation is of profound importance not just to the global economy, but also to society.

Our research presented these functions of finance to various audiences. Whilst we do not argue that we have created the definitive taxonomy on the purpose of finance, it provides a basis for discussion, further enabling us to build our argument as to the connectedness between a purposeful finance system and purposeful corporations. The four functions can be combined in different ways to provide different financial products. In the case of a company which deposits money in a bank, it not only has its money kept safe, but is also enabled to transact with customers and suppliers. It can insure risks. Through intermediation, a company can raise either permanent (usually equity), or repayable (usually loan) capital. In raising that finance, it will often give significant power to those who have provided the capital, which will in turn influence its behaviour.

[6] Rothschild, N. (1977). Meditations of a broomstick. London: Collins.

FIGURE 1: The Purpose of Finance



2. LITERATURE REVIEW ON THE PURPOSE OF FINANCE

As part of our research, we looked at what academic work had been done on the "Purpose of Finance". Given the large number of academic institutions teaching and researching finance, we hoped the literature might help us reflect on the functions of finance and how these can best be delivered to create a purposeful outcome. We therefore commissioned two studies of the literature, one in 2017 and more recently, a more in-depth review of academic journals in 2019.

In appendix two, we discuss the approach taken. By no means is this an 'absolute' or 'exhaustive' review of the literature. It does, however, help to build our hypothesis that there remains a scant number of sources, be they from academics or practitioners that discuss this question in any structured rigorous fashion.

Throughout the literature, there is a general agreement that the purpose of finance is to serve the outside world. For example, in his book, Finance and the Good Society, Shiller states, "Finance is not about making money per se…it exists to support other goals-those of society". It provides "stewardship to protect and preserve the assets needed for the achievement of and maintenance" of individual and societal goals[7]. Purpose is thus very broadly conceived. Others take a similar approach. Dembinski [8] argues that "a healthy financial sector serves both the common good of society, as well as the wellbeing of individuals who participate in it". Beneich and Biehl [9] that a narrow view of the purpose of finance is "to create and preserve wealth" but that it also has wider functions, "such as the development of the wider economy, social harmony and stability". These broad definitions, while emphasising the broad influence of the industry, are of little help in defining specific, measurable goals.

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[7]Shiller, R. (2012) Finance and the Good Society. Princeton University Press
[8] Dembinski, P. (2009) 'Finance: servant or deceiver'. Palgrave McMillan
[9] Beinisch, N. and Biehl, C. (2012) What role does the PRI play to facilitate the social role of finance across asset classes? In: The Societal Function of Investment Asset Classes: Implications for Responsible Investment, 04 October 2012, Harvard University

The finance literature itself is more specific in defining functions. Although language differs somewhat between authors, all have an overlap with the six functions defined by Nobel Prize winning economist, Robert Merton and later again by Merton and Bodie[10]. Those are to:

1. provide a payments system
2. pool funds for investment in large indivisible projects
3. transfer resources through time and across geographies and industries
4. manage uncertainty and risk
5. provide information in a decentralized system
6. manage asymmetric information.

Many introductory economics textbooks discuss the functions of finance as the matching of borrowers and savers, or in other words moving funds from people who have a surplus to people who have a shortage, which might fall under Merton's third function[11]. Others suggest additional purposes, such as providing liquidity, or developing new processes[12]. Some are more specific in describing the approaches the industry must take in fulfilment of its goals, Naik[13], for example, notes that risk can be managed only by diversification, or by sharing it.

Kay[14], offers a list of four functions, consistent with, and perhaps more practical than those suggested by Merton: managing a payments system; matching lenders and borrowers; helping us to manage personal finances, and the risks associated with everyday life and economic activity.

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[10] Merton, Robert C. "A Functional Perspective of Financial Intermediation." Financial Management 24 (Summer 1995): 23-41

[11] Mishkin, F. (2004). The economics of money, banking, and financial markets. Boston, Mass.: Addison Wesley. Ireland, P. (2008). Lecture notes on money banking and the financial system. [online] Available at: http://www2.bc.edu/~irelandp/ec261.html
Bradfield, J, (2007), Introduction to the economics of financial. Oxford University Press.

[12] Epstein, G. and Montecino, J. (2016). Overcharged: The High Cost of Finance. Roosevelt Institute.

[13] Naik, N (2008). Hedge Funds: Performance, Risk, and Capital Formation. The Journal of Finance, 63(4), pp.1777-1803.

[14] Kay, J (2015), Other People's Money: Masters of the Universe or Servants of the People?

Within the finance literature, there is a stream of literature around financing of the firm and how this affects its nature. [15] They nonetheless still struggle to make more explicit links to the purpose of a corporation and the nature of the finance industry that funds it. Having reviewed ten of the most prominent journals in finance, (listed in Appendix Two) we found literature that discussed the nature of the firm and parts of the finance system, instruments of the finance system, and associated theories around it. But there was nothing which drew together the corporation and finance system, and analysed the dependency and interconnectedness of the two systems.

We would also make two further comments on the literature. First, there is a danger that it conflates "enabling functions" in finance, such as successful innovation, or the management of asymmetric information, with the ultimate services it provides for the outside world, such as providing a payments system.

Second, and related to that observation, there is a danger that some of the externalities in undertaking the functions of finance, particularly the positive ones, are themselves viewed as purposes. For example, certain forms of intermediation allow price discovery, just as trading vegetables in a market allows price discovery; knowing market prices may have positive side effects, but price discovery is not a primary purpose of finance. The same might be said of "the separation of ownership and management", which intermediation makes possible, and the concomitant requirement to "monitor the management" if such separation is to prove safe. We would again not dispute the value of separation, or the necessity of monitoring. But we would view them as enablers of an effective system of intermediation rather than as ends in themselves.

But perhaps our most significant observation is that we have found no studies which, having defined the functions of finance, have gone on to systematically measure how well the industry has performed its role. Some, for example Kay, offer examples where the finance industry appears to be less than purposeful. But Merton and Brodie, and indeed the textbooks of finance have a tendency to assume that, having defined the purpose of finance and having noted that financial markets are competitive, it can be assumed that this "will cause the changes in institutional structure to evolve towards greater efficiency in the performance of

[15] Rajan, R. (2012). Presidential Address: The Corporation in Finance. The Journal of Finance, 67(4), pp.1173-1217.

the financial system".[16] In other words, the finance literature reflects the critique central to the Future of the Corporation Project. It does not 'pose questions about where we are going because, like a blind man guided by the invisible hand of a good Samaritan, [through markets and competition], we are led to our desired destination'.[17]

We have found only one set of studies which have sought to measure efficiency in a way that is directly related to how the finance industry performs its functions. In particular that of Thomas Philippon[18], to whose work we will refer later on in this paper. However, with that possible exception, we have discovered few studies of the efficiency of the finance industry overall which have started by defining either the functions or the purposes against which efficiency might be measured.

For the reasons given above, and because of the nature of Merton and others' categorisations, the task of measuring the performance of the finance industry is extremely difficult. That in turn makes it problematic to assess whether or not finance is fulfilling its functions or working efficiently. This is a huge gap in our knowledge, and one which might be considered a major stumbling block to anyone—for example a regulator—whose aim was to make the industry perform better.

That is why we have suggested our own set of purposes for finance. All of these are functions which directly benefit the outside world. All of them are ones which are, at least to some extent, measurable. We would note that different financial products incorporate a variety of functions to fulfil their purpose. For example, a pension system will be required to keep our money safe, to intermediate, and to allow risk sharing, particularly as regards longevity risk. Other functions will have important enabling functions; thus, while the ultimate purpose of a stock exchange is to assist effective intermediation, it does this by allowing effective price discovery and appropriate levels of liquidity.

We would note that, absent any definition or measurement of function or purpose, it is difficult to prescribe what changes to the financial system will be beneficial. For Merton[19], and for previous writers, this problem has just been ignored, or assumed away by positing

[16] Merton, R, (1995) Op cit
[17] British Academy (2019) Future of the Corporation. Principles for Policy Reform.
[18] Philippon, T. (2015). Has the US Finance Industry Become Less Efficient? On the Theory and Measurement of Financial Intermediation. American Economic Review, 105(4), pp.1408-1438.
[19] Merton, R, (1995) Op cit

that competition will always lead towards a more efficient system. However, as we shall see, the evidence suggests that this assumption is unsafe. [20]

[20] (1) For example Mishkin "The Economics of Money Banking and Financial Markets", or Bradfield "Introduction to the Economics of Financial Markets". (2) For example Schafer, Scholtens and Signori "Responsible Investment in Times of Turmoil" (3) For example Mishkin "Policy Remedies for Conflicts of Interest in the Financial System"

3. EVIDENCE OF THE EFFECTIVENESS OF THE FINANCE INDUSTRY IN DELIVERING PURPOSE

It is difficult to conceive of a modern economy which lacks an effective financial system. Indeed, its services are so beneficial to society that many early entrepreneurs who started financial institutions were known as philanthropists. They sought to address the problems people faced when they couldn't get access to financial services. Examples are littered through history, from the first "people's bank", the Trustee Savings Bank set up by a Scottish minister to serve his flock, to the work of Grameen Bank's Mohammed Yunus, which provides capital to the poorest of Bangladesh through micro-finance. What Yunus was doing was not, in theory, different from a loan shark. In theory the same, in practice totally different. One has a clear and positive purpose, the other undertaken with little regard to the welfare of the consumer. Of course the finance industry is not alone in offering products which seem to be of little benefit. Indeed market economies often allow poor products to be introduced. But they do not survive for long because those which fail to meet consumer needs fall by the wayside.

It is this process of "creative destruction" as described by Schumpeter[21], which ultimately leads to improvements in quality and lowering of price. And those improvements can be measured. We can note over time the greater speed, safety and comfort of a car, and its lower cost and emissions. We can chart the growing efficacy of drug treatments, and are rightly scandalised when mis-prescription occurs. In the case of finance, similar improvements should be apparent.

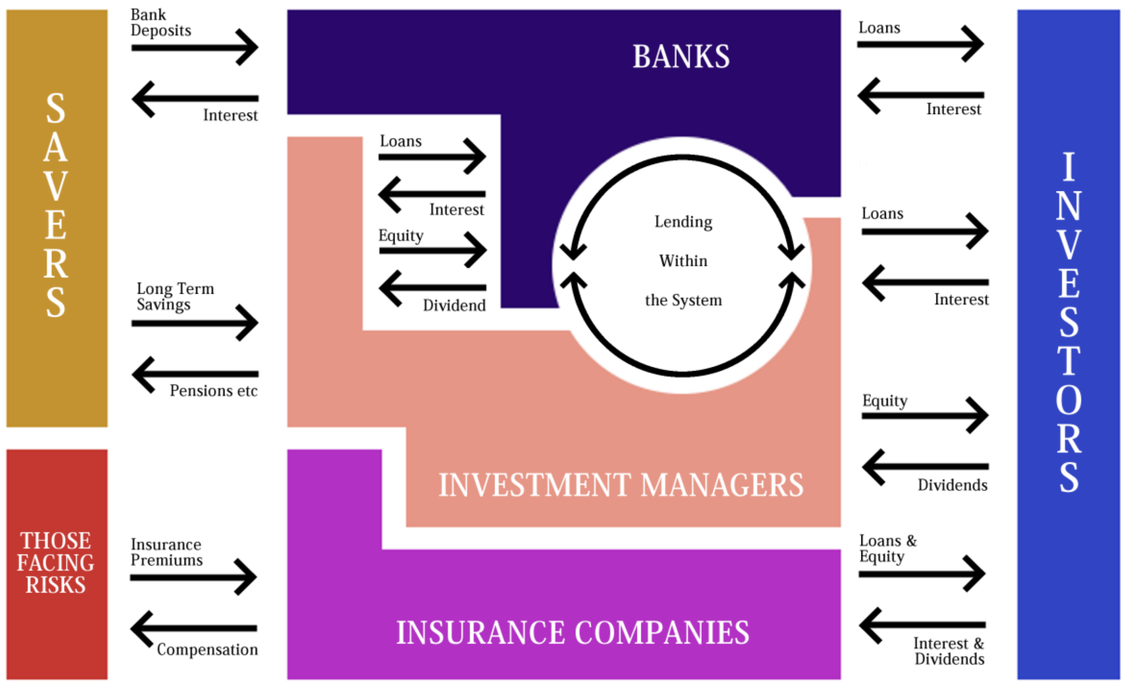
Yet as we shall see, the evidence, both anecdotal and empirical, suggests that the finance industry not demonstrating such improvements. The Chair of the UK's chief financial regulator suggested that much of what was taking place was 'not socially useful'. The President of the American Finance Association has made similar comments.[22] The head of the US Federal reserve that financial innovation was largely rent seeking[23]. Their comments

[21] Schumpter, J. (1942) Capitalism, Socialism and Democracy.
[22] Zingales, L. (2015). Presidential Address: Does Finance Benefit Society?. The Journal of Finance, 70(4), pp.1327-1363.
[23] Volker, P. (2019). 'The only thing useful banks have invented in 20 years is the ATM'. [online] Available at: https://nypost.com/2009/12/13/the-only-thing-useful-banks-have-invented-in-20-years-is-the-atm/ [Accessed 16 Nov. 2019].

are supported by empirical data from Thomas Philippon who has discovered little or no increase in the efficiency of intermediation in over a century, thus implying that the finance industry that funded the construction of railways over 120 years ago had a similar level of productivity to the one which today funds the internet.[24] We will return to these issues later. But before doing so we need to address the question of who the finance industry is there to serve; how a purposeful system would interact with the companies to whom it provides finance; the gap this suggests with current practice; and finally what measures might help to fill any such gap.

3.1 WHO IS THE FINANCE INDUSTRY THERE TO SERVE? WHAT ARE THEIR LIKELY NEEDS AND HOW MIGHT THIS AFFECT COMPANY FINANCING.

<u>FIGURE 2: The Financial System</u>



[24] Philippon, T. (2015) Op Cit

It is generally acknowledged that the purpose of the financial system is to serve the outside world. In particular its central role, and the one which gives it most influence over company behaviour is its role in providing them with funds, which will in turn support purposeful output.

The chart above is a simplified illustration of this system of intermediation. On the left are those who have excess cash which they are saving, or who are using the financial system to hedge against some unforeseen risk; on the right the users of those savings, typically companies, or households which are borrowing. The finance industry thus has two sets of customers; the providers of funds and the users of funds.

We would note that if the financial system is to be stable, then it is a necessary condition that the promises it makes to those providing funds must be matched by the promises it accepts from those who use those funds. Where this is not the case, specific protections need to be put in place. So for example, a bank can accept short term deposits, and lend long term only if it knows that the central bank will come to the rescue if everyone decides to withdraw their deposits.

Therefore, when providing funds to companies, the financial system needs to be careful that the terms on which finance is provided match the obligations due to those who have provided the funds. With that, it is worth reviewing the nature of the savings made by savers, since this will, and indeed should affect the type of finance offered to companies. (In this example we have concentrated on some key characteristics of UK savings. We recognise that the financial system is globalised, and that a full analysis would review all sources of funds. This is beyond the scope of this paper.)

In the UK household private financial and pension wealth amounts to around £7.0 trillion. Of that £5.4 trillion is represented by pensions, £1.6 trillion by other assets.[25] As regards the pension wealth, on our estimates, around £3.25 trillion of that is funded—ie supported by financial assets[26]. So some two thirds of financial assets are provided from the pension

[25] Office for National Statistics (2018). Wealth in Great Britain Wave 5: 2014 to 2016. p.p10.
[26] Some is the promise made by the government to fund public servants pensions, and some represents the underfunding of other pension plans.

system. The scale is prodigious. For example, the combined wealth of the Top 1000 families in the Sunday Times Rich List, is around £0.77 trillion, less than a quarter of funded pension wealth.

We would note that pension promises are long term; indeed the "average life" of an open pension plan might be around 25 years. We would also note that most families in Britain have some pension provision. Finally, we would note that most pensions are invested in many hundreds of different companies, in order to reduce the risk of any one of them failing.

Thus, as far as the UK is concerned, a financial system that was serving its purpose for those providing funds, would be likely to be long term in its perspective (reflecting the long term nature of pension liabilities), it would be cognisant of the need to serve the many millions who needed a pension, and thus of the importance of upholding a purposeful corporate system, where profit was not being made through zero-sum game activities, or by externalising costs.

3.1 WHAT IS THE ROLE OF THE FINANCE INDUSTRY IN PROVIDING FUNDS TO COMPANIES AND WHAT POWERS ARE ACCORDED TO THE INDUSTRY TO FULFILL THIS ROLE?

The financial system must also cater for the need of the users of funds: households, companies and governments. Our particular interest is in the way they fund and influence companies.

There are two principle instruments through which funds are provided to companies: Debt and Equity. Debt is provided either by borrowing from a bank, or larger companies can raise money by issuing a bond. In both cases, there are strict contractual terms as regards interest repayment and security. Bonds are often tradeable; hence, the owner of the bond can realise its value, (albeit at an unknown price) should the need arise.

Equity is permanent capital. The terms on which it is given are not contracted. Rather the directors of a company have a fiduciary duty to serve the interests of all the equity holders in their company (not just the biggest shareholders), as well as giving consideration to other stakeholders[27]. Equity holders are, in turn, given significant powers. They approve the election of directors. They approve the auditor. They discharge the board through the approval of annual accounts and have various other powers. Equity holders receive a financial reward through the payment of dividends. In the case of public companies, they are able to sell their shares at the market price.

Equity holders thus have huge influence over the way the company is run. These powers are only lost if the company is unable to pay its debts, in which case powers fall to the creditors, typically led by the bank or the bondholder. Either way, the financial system is very influential. The Principles for Policy Reform suggest that the power of the financial system might ultimately be reduced to help support purposeful companies. In this paper we ask a related question which is whether a financial system which focussed on purpose, might itself promote the emergence of purposeful companies.

[27] A fuller definition of directors duties is given in the Companies Act, in particular Sec 172 CA (2006)

4. WHAT MIGHT A PURPOSEFUL FINANCE SYSTEM TO LOOK LIKE. IN PARTICULAR HOW WILL IT SUPPORT INVESTEE COMPANIES?

We have already noted that, given the nature of the saving into the financial system, the funding of companies might be likely to be long term in its perspective. (reflecting the long term nature of pension liabilities) It would be cognisant of the need to serve the many millions who needed a pension, and thus of the importance of upholding a purposeful corporate system, where profit was not being made through externalisation or zero-sum game activities.

Finance will, of course, continue searching for returns in order to meet pensions and other liabilities, but if it is serving the interests of the provider of funds, it will not promote these at the expense of the society in which its savers live. So how might we envisage such a system would work? Below we cite three examples of its likely behaviour.

<u>Stewardship Principles of an Institutional Investor</u>

One institution which has been quite explicit about the characteristics it wishes to see from the companies it invests in is Hermes Fund Managers. These are expressed in the Hermes Principles[28], which lay out explicitly what investment institutions should expect of public companies, based on the needs of the many thousands of people whose pension funds it managed.

The Hermes Principles are adamant about the rights of shareholders and the need to generate value over the long term. Their starting point is enlighted shareholder value on behalf of many savers. However, they are clear that profit should not be made by externalising costs, and that stakeholders should be treated fairly[29]. They also insist on the need for companies to

[28] The Hermes Principles (2002). The Hermes Principles. London: Hermes Pensions Management Limited.
[29] The Hermes principles were written by one of the authors of this report. As regards ethics, they state that "ethical behaviour by companies is likely to involve some notion of fairness and reciprocity; that managers seek to understand the position of those whom their action affects, and that they deal fairly with them"

be clear about their strategy, and the need to focus on those activities where they have a competitive advantage.

The Hermes Principles might suggest that a purposeful financial system would be supportive of purposeful companies provided that purpose was not pursued at long term private and social expense to shareholders. In this case, shareholders are defined as the many millions of people saving for a pension.

Universal Ownership

Similar themes emerge from those who have noted the degree of diversification of pension and other investment portfolios, and the behaviour which this should engender. This is often described as Universal Ownership (UO) Theory. A helpful discussion of the literature on Universal Ownership can be found in a recent article by Ellen Quigley[30], which discusses its significance for fund managers considering how they might respond to environmental issues. Universal Ownership notes that many institutional investors own ‘a more or less representative slice of the economy and cannot reasonably sell out of individual companies. In particular, they would wish to discourage ‘companies whose activities add costs to … other companies in its portfolio’.

Universal Ownership has some theoretical downsides for example it might encourage monopolistic practices[31]. However, it is also likely to find investors championing solutions to systemic risks, which damage portfolios rather than just individual companies.

Indeed, one might see this in action in the efforts of investors to find a solution to global warming. Very large groups of investors have promoted more radical climate action[32], and have lobbied companies to cease investing in fossil fuels[33]. Thus, a combination of the very

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[30] Quigley, E. (2019). Universal Ownership in the Anthropocene. SSRN Electronic Journal.
[31] See for example the arguments made about airline pricing. Stanford Graduate School of Business. (2019). The Biggest Antitrust Story You’ve Never Heard. [online] Available at: https://www.gsb.stanford.edu/insights/biggest-antitrust-story-youve-never-heard The authors of this paper regard this study as questionable. It can find only one example of the phenomenon (by accident there should be many incidents given the level of diversification of funds). Nor have they suggested any mechanism by which fund managers would encourage companies to raise individual product prices.
[32] For example Ceres, or the Institutional Investor Group on Climate Change
[33] For example Climate Action 100

large number of savers, and the broad diversification of investment means that a purposeful financial system will promote many of the characteristics of the purposeful company, provided that purpose is not achieved at a private or social cost. We should therefore turn our attention to the cost of pursuing the purposeful corporation.

Is pursuing purpose costly to shareholders?

And indeed the evidence suggests there is little evidence that profit comes at the expense of purpose. Quite the reverse. While we should be cautious about the data, a survey of the literature on purpose and performance has been undertaken for the Big Innovation Centre.[34] Far from discovering that there was a trade-off between purpose and profit, it concludes that while the evidence is not definitive, 'the payoffs from purpose are…reflected in share price performance, improved accounting and operational performance, more valuable innovation and lower cost of capital'.

So, provided that it took a long term view of company profitability, rather than encouraging a short term jump in share prices, a purposeful financial system should promote purposeful companies. Indeed that is already the language that it is speaking. For example, Larry Fink, is CEO of Blackrock, the largest fund manager in the world, which holds around 5% of global shares in thousands of companies ultimately representing many millions of savers. In his annual letter to the leaders of those companies, he urges them to view purpose as 'the company's fundamental reason for being. Purpose is not the sole pursuit of profits, but the animating force for achieving them' [35] Critics may say that such statements have yet to be adequately demonstrated in practice. Nevertheless, the desired direction is clear.

In theory then the characteristics of our financial markets would suggest that at least in theory, they should encourage the promotion of purposeful companies. They should be long term since the average life of an investment is long term. They should be sensitive to social

[34] The Big Innovation centre (2016). The Purposeful Company: Interim Report. [online] London. Available at: https://www.biginnovationcentre-purposeful-company.com/wp-content/uploads/2017/11/thepurposefulcompany_interimreport.pdf
[35] Corpgov.law.harvard.edu. (2019). Purpose & Profit. [online] Available at: https://corpgov.law.harvard.edu/2019/01/23/purpose-profit/.

issues, in particular to accountable governance. They won't want to profit at customers expense.

Financially they will still seek profits. Companies cannot decide to be charities. However they will seek profit through purpose rather than at its expense, and note, with Larry Fink that, 'in fact profits and purpose are inextricably linked'.

Some may suggest this view is overly optimistic, even Panglossian. However it does suggest that the problem which needs to be addressed is not occuring because the characteristics of financial markets are necessarily inimical to purposeful companies. Rather the big gap, and (pragmatically) the easiest to address is not the gap between purposeful finance and purposeful companies. It is the gap between the finance industry we have today, and the purposeful one it ought to be. Unless that gap is filled, it will prove difficult to promote purposeful companies.

4.1 HOW FAR IS THE FINANCE INDUSTRY TODAY FROM THE PURPOSEFUL ONE WE SEEK

As mentioned above, there are few, if any, studies that define and measure how well the finance industry is performing its basic functions, let alone how well these are translated into purposeful activity. If we were to rely on popular perception, the results would be grim. In a Bank of England study, citizens were asked to choose one word to describe the finance industry, and its development. The most popular word chosen was "corrupt".

FIGURE 3: Perceptions of Finance

There is one study which aims to measure the efficiency of the financial services industry. It was undertaken by Thomas Philippon of NYU, and has been repeated for European countries by Guillaume Bazot. It begins with the assumption the purpose of the finance industry is to serve the outside world, and that the principle service it provides is to intermediate: accepting money from those who save, and placing it with those who invest. Philippon tracks the amount of "net" intermediated funds in the USA over 130 years today (i.e. eliminating any borrowing or lending which takes place within the financial system itself). As Figure 4 below shows, the scale of intermediation has increased considerably, from around one times the GDP in 1880 to four times.

Figure 4 also shows the cost of running the finance system has also grown from 2% of GDP in 1880 to 8% today. Since the growth in the money intermediated, and the growth in the aggregate cost of the finance system are the same, this suggests that there has been no improvement in the productivity of the finance industry over 130 years, illustrated in Figure 5. Philippon's numbers adjust for the mix of borrowing and lending, but this makes little difference to the overall conclusion. At the aggregate level, and despite technological improvements, little productivity improvement is discernible.

FIGURE 4: The scale of the US Finance Industry and Funds Intermediated and a Percentage of GDP

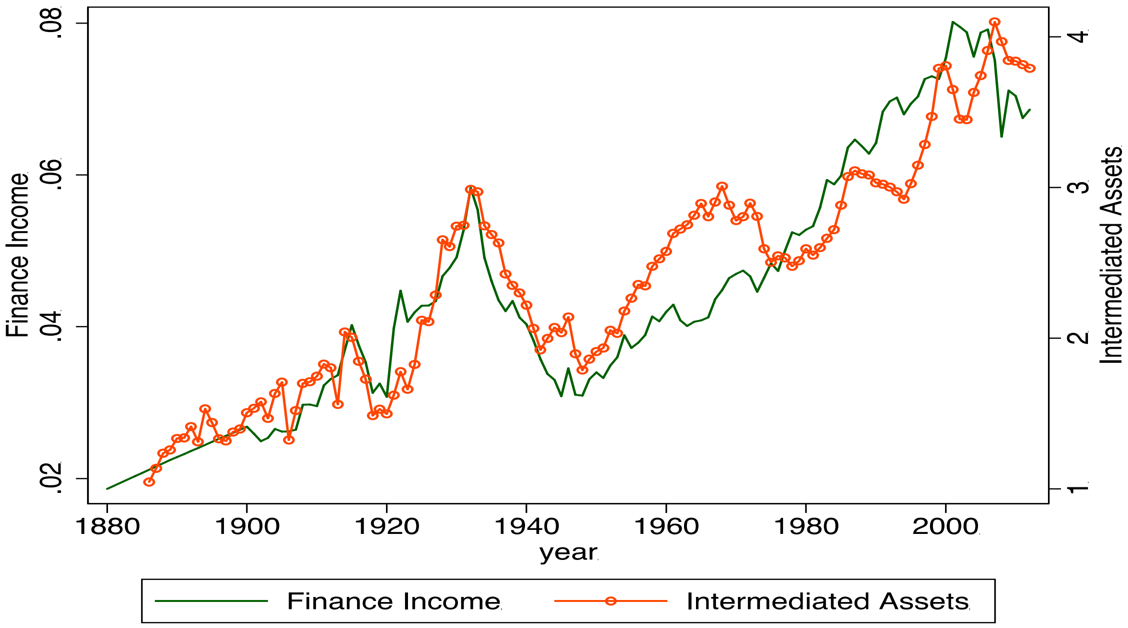
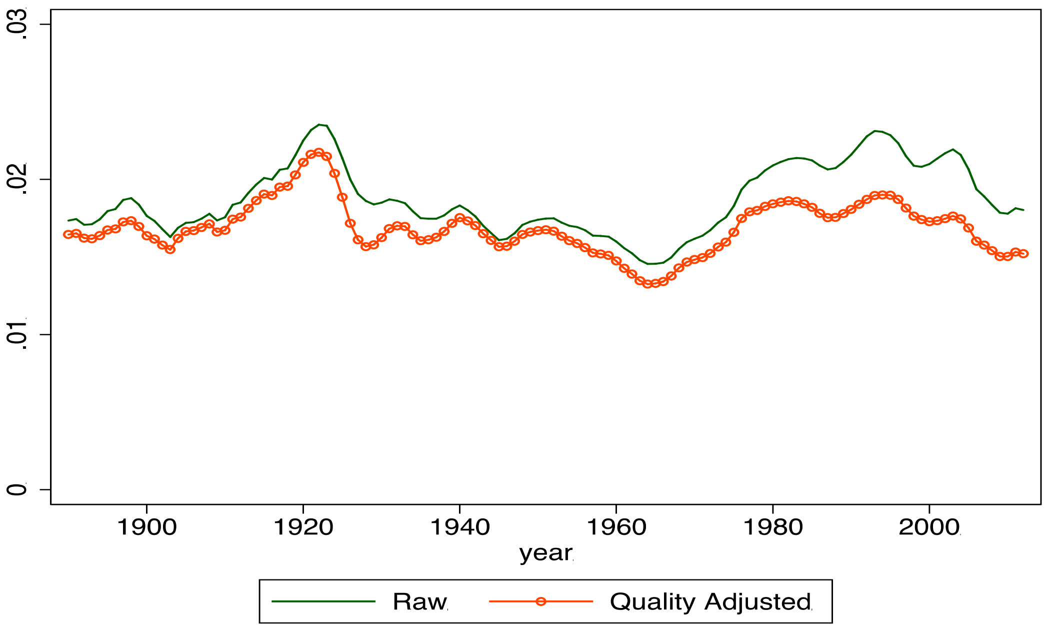


FIGURE 5: The cost of intermediation over time (percentage)



With this evidence in mind, it is interesting to reflect on Paul Volker's observation on the industry. Volker was formerly Chair of the Federal Reserve Bank of the USA.

> I found myself sitting next to one of the inventors of financial engineering… I knew who he was and that he had won a Nobel Prize. I asked what all the financial engineering does for the economy and what it does for productivity. Much to my surprise he [said] it does nothing. I asked him what it did do and he said that it moves around the rents in the financial system and besides that it was a lot of intellectual fun[36].

Moving around the rents is simply not a purposeful activity. And it is one entirely divorced from providing appropriate finance and stewardship of companies.

Similar studies on the productivity of the finance industry have been undertaken for European countries by Guillaume Bazot. They paint a similar picture. However one remarkable difference is that *the UK seems to have a lower cost of intermediation than other nations*—albeit with little improvement over time. Properly promoted, one might think this would be a huge competitive advantage.

Let us now focus on how well the institutions of finance fulfil their purpose in providing funds and stewardship to companies.

4.2 HOW WELL DO THE INSTITUIONS OF FINANCE PROVIDE FUNDS

British companies are typically funded through loans provided by banks, and through bonds and equity provided by fund managers and insurance companies. [See Figure 2]. This service, if properly provided, creates huge value.

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[36] Corpgov.law.harvard.edu. (2019). Purpose & Profit. [online] Available at: https://corpgov.law.harvard.edu/2019/01/23/purpose-profit/.

Yet anecdotally, it seems that practices have been allowed to develop which aren't delivering to purpose. For example, the scandals at HBOS and RBS suggest that those banks were lending to companies and then abusing the fine print of the loan agreement to take control of companies, driving them to bankruptcy while talking large fees[37].

More systematically, however, one can see institutions which seem to have come adrift from their original purpose. Stock exchanges are one such example. Having emerged in the early 17th century, stock exchanges came about as a way to allow companies to raise permanent capital, typically through the issuance of shares, while allowing those holding the shares to sell them. Thus, companies were provided with permanent long term capital while the shareholder was rewarded with a dividend while they held the share and with a cash realisation when it was sold. Trading on stock exchanges thereby created long term, permanent capital.

Today, the volume of trading on stock exchanges has increased dramatically; indeed on the London Stock Exchange the value of trading is now ten times greater (as a percentage of the market value of quoted companies), than it was just fifty years ago. Yet the number of companies quoted has actually fallen. Far from providing new permanent capital, today as much money is paid out by exchanges than is raised on them[38].

Indeed, the trading of shares seems to have become an end in itself rather than a way to support long term investment. Take, for example, Michael Lewis' book Flash Boys, which describes High Frequency Trading (HFT). HFT effectively involves extracting information about stock market trading fractions of a second before a deal would be concluded and 'arbitraging' the trade. In the words of Adair Turner, former chair of the FCA, it is 'not socially useful', in raising funds. Some forms of HFT, if done in real time, would in fact be deemed 'front running', which is illegal.

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[37] For HBOS, see Section 3.5 of Wikipedia about Operation Hornet see En.wikipedia.org. (2019). HBOS. [online] Available at: https://en.wikipedia.org/wiki/HBOS. For RBS see En.wikipedia.org. (2019). Royal Bank of Scotland. [online] Available at: https://en.wikipedia.org/wiki/Royal_Bank_of_Scotland#Allegations_of_asset-stripping_small_business_customers

[38] Wainwright, W. (2019) What are stock exchanges for and why should we care? London: Pensions insurance corporation.

Equity stock markets are there to provide permanent capital. Yet, as a result of the huge increase in the trading of shares, companies often consider them to be short-term. The reason may be that the fund management industry is seen to put little effort into the stewardship of the companies whose shares it own, but rather concentrates on the trading of shares to demonstrate 'outperformance'. By its nature the trading of shares is a short term activity, it is costly, and even before those costs is, in aggregate, a zero sum game. So while some trading is important to allow companies to raise permanent capital, and allow savers to adjust their portfolios, the scale of trading in today's markets seems well in excess of what is purposeful. As one workshop participant put it, if the industry is not 'corrupt', as suggested in Figure 3, it is at least 'perverse'.

Other features of the finance industry and its institutions have similar characteristics. They are simply not focussed on meeting the purposes which address the needs of savers or borrowers.

4.3 HOW WELL DO THE INSTITUTIONS OF FINANCE PROVIDE STEWARDSHIP

By law, company directors are at a minimum required to promote the success of the company, for the benefit of the shareholders "as a whole", whilst having regard for other stakeholders. [Sec 172 of Companies Act 2006]. As discussed above, the beneficial owners of most public companies are millions of individuals saving for their pensions. Therefore, promoting their benefit while having regard to stakeholders is at least a starting point for "enlightened shareholder capitalism".

One would think that a purposeful financial system, would work in the interests of those whose savings it manages. It would want to promote profitable purposeful growth which did not externalise costs. As we have noted, shareholders have substantial powers to do so, including the appointment of directors, and auditors and the approval of their remuneration.

But today's fund management industry is not structured to deliver stewardship. Indeed, most fund managers are not judged by the absolute performance of the companies in which they invest, be it financial, social or environmental. Rather, they are judged by their financial performance relative to other fund managers investing in a similar class of assets. Performance is measured in terms of relative performance—termed alpha—not in terms of "beta", the performance of companies in aggregate. Yet it is beta which will ultimately be the most important in determining the outcome for the saver.

This is not to say that fund managers entirely ignore their stewardship responsibilities. Blackrock, for example, has around 40 people dedicated to the stewardship of the companies in which it has invested client monies. It is one of the largest such resources of any fund manager. Blackrock has 15,000 employees, and invests over $6 trillion in many thousands of companies, so its stewardship resource is relatively modest. Yet Blackrock would claim to be something of a leader in the field.

So the stewardship function of purposeful fund management is inadequately served. Much resource is devoted to other less purposeful activities.

5.0 CREATING A MORE PURPOSEFUL FINANCE INDUSTRY

The previous sections of this paper have set out some characteristics one might expect from a 'purposeful' finance industry, and some reasons as to why we currently don't have such an industry. We have also considered the impact this has on the purpose of the corporation. This final section will consider how we might find ways to create a more purposeful finance industry. In particular we will look at initiatives in politics, academia and the industry itself. We will also examine the role fintech might play given its prominence in the new wave of financial institutions that are emerging.

5.1 WILL FINTECH SOLVE THE PROBLEM

It is clear the fintech revolution is upon us. It's the buzzword that echoes across the City as new companies emerge with leaders who do not have traditional finance industry backgrounds, coming instead predominately from the technology sector. In the UK, it is estimated there are around 1,600 plus fintech firms, with this figure expected to double by 2030. [39] With this projection comes the hope that fintech could be the driver in delivering a more purposeful finance industry.

Technology has the power to increase transparency and efficiency, reduce cost, and give the most vulnerable access to financial services. Society and businesses both stand to gain from these changes, as incumbents are challenged by the new wave of digital innovation. And it is rapidly transforming the financial services sector with mobile banking apps, robo-advisors, peer-to-peer lending services, crowdfunding campaigns and cryptocurrencies – these are all Fintech innovations.

Fintech advances are made possible through data and efficiency. Whether they form the solution to a more purpose driven finance industry is yet unclear. This is dependant not on the technology but on the strategy and motivations of those creating the business model. We cannot take it for granted that innovation will lead to customer benefit. Indeed as we have noted, the evidence presented by Thomas Philippon suggest that in aggregate, technology has made little difference to productivity over the past 130 years.

[39] Department for International Trade (2019). UK Fintech, State of the Nation.

Let us consider one example: a fintech business delivering personal loans.

The core of the business model is to develop a platform that uses alternative data sources, such as utility bills and predictive information, in order to understand their customers financial lives and to assess their ability to repay. From this data, they are able to create products tailored to their customers, for example by providing loans based on cash flow rather than on collateral. This has significant advantages in opening up borrowing to those without significant wealth or assets. And as operational efficiencies increase with improved technology, costs decrease and fintech platforms can afford to serve harder-to-reach customers who need small loans, something that traditional banks won't do.

Yet the same data and efficiency advances that allow new customers to be included can just as easily allow them to be exploited. Predatory lenders can target a larger, often less financially savvy audience, providing easy access to capital that comes with lots of strings, such as hidden fees and high interest rates, leading to a cycle of over-indebtedness.

Fintech shouldn't be seen as silver bullet to solving the issue around a more purposeful finance industry. There is an "ecosystem" that motivates the entrepreneurs, determines industry practices and ultimately shapes the business models of finance companies. This ecosystem needs to be one which encourages purpose driven activities, and allows them to flourish. In this next section, we will explore this further looking at some suggestions for reform, that would help ensure that markets, competition, institutions, incentives, cultures, regulation and training can combine to create a more purposeful finance industry.

5.2 WHAT NEEDS TO BE DONE TO CREATE A MORE PURPOSEFUL FINANCE INDUSTRY?

This section explores what might be done across government, education and the industry itself to enable a fundamental shift in thinking to a more purpose driven industry. All must recognise that where markets are characterised by "asymmetric information", it must not be assumed that the invisible hand of markets will alone deliver purposeful outcomes. Other approaches are also likely to be needed. We do not claim that these recommendations are comprehensive. Rather, they set a direction for reform, and an opportunity to begin a discussion as to how change might occur to deliver a more purposeful industry.

We should start by looking at our education system, which provides the source of talent for the industry, and the source of intellectual capital on which the business models and practices of the finance industry are built. Be it through graduate or undergraduate studies, the financial services industry in the UK is a major employer of graduates. Finance is a popular subject, one that for many graduates is the key to securing a first step on the career ladder in the industry. Yet, when we examine the curriculum, there seems very little that examines the purpose of the industry, or even its basic functions, and how they can best be achieved.

Teaching is firmly rooted in the models of neo-classical economics. These are precisely the ones which suggest that the invisible hand of markets will alone lead to good solutions. Such a model has strengths. But it is entirely inadequate to describe how finance can best fulfil its purpose. These students will in time be the leaders of their industry. If they are to be purposeful, they need to learn the different disciplines that can help guide the industry to its fulfilment. Our first recommendation in delivering a more purposeful finance industry would be that **finance needs to be taught at undergraduate and postgraduate levels with an emphasis on purpose. This needs to be an integral part of the core curriculum. Academic research should similarly be encouraged to investigate purpose and how it is best realised.** Given its membership, the British Academy might play a particularly influential role in fulfilling this recommendation.

Connected to this, our second recommendation focuses on the way in which professional qualifications are drawn up. Professional qualifications accredit the skills of those within the industry. They are important in delivering high standards of learning. They also hold an important role in ensuring that purpose is an important part of professional conduct and practice. In accrediting doctors, we take it for granted that not only do they understand the technicalities of medicine. They also commit only to work on behalf of their patient. Indeed, the Hippocratic Oath requires such behaviour. Finance professionals should similarly be able to demonstrate their commitment to delivering a purposeful service. So, our second recommendation would be that **professional qualifications for the finance industry should support purpose in the same way as they do in the medicine, ensuring that those who pass these qualifications are not just technically qualified but understand and commit to the purpose of the profession they practice.** This might be associated with the introduction of a “Hippocratic oath” for finance professionals.

Workshop participants also felt it would be helpful if **all of those who use the finance industry have a basic financial education**, just as those who use the health system take some responsibility for their own health. We would conjecture that such an education might focus on those financial services which are needed as a 'utility service'; bank accounts, pensions, mortgages, business loans and insurance.

Regulation is essential and should help the industry fulfil its purpose. Yet it has been a mixed blessing. Arguments exist on both sides. On the one hand is the argument that the industry cannot be trusted, on the other is the case against heavy-handed regulation, arguing that it is costly to both good and bad suppliers of financial services. What is clear is that regulators have never been explicit in their promotion of a purposeful financial system. So our third recommendation would be **that policy makers and regulators seek to adopt the lens of purpose when looking at new rules.** Before new regulation is adopted, they should be explicit about their "theory of change"; how the regulation in question will create a more purposeful industry. They should regularly test whether their assumptions have proved correct, and learn from those assessments. In particular, they should note that changes in one part of the financial services industry have knock-on effect to others. Regulators need to be explicit about this. If, for example, accountancy standards are changed so that they are no longer based on the principle of "prudence", that the regulators of banks will need to take this into account in determining appropriate solvency levels. If the promises made to savers must be guaranteed, that this will restrict the risk capital available to companies.

We should also **revisit the Terms of Reference of our regulators.** Many have a remit that tend to reflect the assumption that markets and competition are adequate policy leavers to deliver good outcomes[40]. As we have seen, this is not a safe assumption. So, where it is inadequate, they might be offered further powers which, used more sparingly, can allow the industry to fulfil its purpose better. This in turn means they need to create an understanding of what purpose is, promoting this understanding amongst other industry participants. They need a mindset which is **based on purpose** and **metrics** assessing how well the financial system and financial firms are fulfilling it.

[40] The FCA for example is charged with protecting consumers, promoting effective competition and ensuring market integrity.

This may lead to the exploration of **new policy approaches**. For example, today, risk weighted bank capital is almost exclusively based on statistical measures. (Small business lending is the one exception). While such measures are important, they may well be encouraging purposeless trading. Another example would be stock exchanges. We mentioned earlier that, despite huge increases in trading the amount of capital being raised is reducing. Some suggest that much of this trading is, in aggregate, purposeless. Yet might this not suggest there could be room for institutions, taxes or regulations to discourage such activity? We note the creation of the IEX stock exchange in the USA, which has introduced short delays on trading to address the costs paid by bona-fide market users to High Frequency Trading (HFT).

We have noted that, if markets were working perfectly, and everyone had full information, they would ipso facto fulfil their purpose. Current arrangements, however, allow those who manage money to profit at their customers' expense. There is a standard response to this which is to **embed fiduciary duty throughout the chain of agents who manage money.** So for example, a pension trustee owes a fiduciary duty to members. Even a company director owes such a duty through Section 172. Other financial intermediaries typically only need to fulfil their contract. They do not always need to act always in the best interests of the person whose funds they are managing, leave alone considering wider societal impacts. We should further **clarify fiduciary duty,** so that it does not ignore externalities, or encourage free riding. Where such duties do not already exist, **trustee-like bodies could be created and empowered.** The creation of Independent Governance Committees, and the recent discussion of extending their powers, could be a case in point.

Ensuring that a legal obligation exists to act in good faith in the interest of others would allow the question of purpose to be central to the development of strategy and innovation. It would allow us to create the institutional and governance structure to allow markets to work in a benevolent fashion.

We should also be sure that **appropriate institutions are in place to ensure that purposeful financial services can be delivered**. For example that it is possible for citizens to save for a 'pension', meaning an 'income in retirement'. Today, outside the public sector, and despite the fact that we have an effective national system of pension savings, we have no effective system for pension drawdown. Similar observations might apply to the provision of long term funds to private companies. Until the 1980's 3i (ICFC) had a network of local offices providing such funding. Inexplicably this valuable service was abandoned, and is now having to be recreated through the British Business Bank.

We should insist **that the prerequisites for the efficient operation of markets are in place**. For example, today, investment funds do not declare to those who are saving, the full costs of doing so. Markets don't work if customers are unaware of how much they are charged.

Nor are markets likely to work if those who participate in them are given the wrong incentives. As a recent study by NESTA demonstrates, corporate directors are frequently given short term performance targets, despite the insistence by their investors that they wish them build purposeful companies for the long term.[41] The same is true for portfolio managers. **Incentives throughout the system need changed** if it is to be purposeful.

Many other recommendations could be made with the aim of creating a more purposeful industry. We believe that they, and many more positive reforms on policy and practice would emerge if we were **simply to be more informed and explicit about purpose in the conversations and debate around and within the finance industry.** As we discussed earlier in this paper, the purpose of finance is a topic which has seen little debate. We would argue, that if think tanks, policymakers, those developing strategy within our financial services companies started by asking the question "Does this activity achieve a purposeful outcome?" we would see a shift, in institutions, regulations, culture and markets that would embed itself into the way in which our finance industries operate.

One reason for this gap is lack of information. There is, for example, no comprehensive study which has asked the populace what they would like from the finance industry. There is little reliable evidence on how the finance industry is spending its money, and the services which derive from such spending. In other words there is a huge **need for basic research on the services we should expect from a purposeful finance industry.** The authors would suggest that this might best be discovered through citizen juries, and that it might well reveal the 'utility services' which need to be delivered. But amazingly, despite its consuming eight percent of out GDP, this basic evidence is lacking.

[41] NESTA (2019). The Invisible Drag on UK R&D: How corporate incentives within the FTSE 350 inhibit innovation. [online] London. Available at: https://www.nesta.org.uk/report/invisible-drag-corporate-incentives/

5.3 THE PURPOSE OF FINANCE AND THE PURPOSE OF THE CORPORATION

Our argument suggests that these reforms to create a purposeful finance industry will assist in creating purposeful companies. It would invest for the long term; it would use the power of diversification to allow companies to take (idiosyncratic) risk. It would encourage the raising of new funds—both for permanent capital through equity, and through bonds and other loans. As regards stewardship, equity funds would still encourage companies to seek returns, but would be clear that stakeholders needed to be treated fairly, and that companies should not profit through the externalisation of costs. They would actively use their shareholder powers to promote social and environmental outcomes, as well as financial ones. Indeed one can see much of this taking place in scores of initiatives such as the Principles For Responsible Investment, or Climate Action 100.

But although much useful activity is taking place, and many worthy words spoken in support of purpose, today's finance industry can hardly be deemed purposeful. If it were reformed, along the lines we are suggesting, how might that affect its ability to respond to the challenges presented in Principles 7 of the Policy Paper, and how might it impact on some of the other recommendations made?.

Principle 7 aims to create long term sources of finance, and for equity holders to encourage a long term perspective:-

'Corporate financing should be in a form and durationthat allows companies to fund more engaged and long term investment in their purposes'

The reforms we have suggested would support this principle, and its objective of encouraging long term investment. Concerningly there is a gap in finance for smaller private companies seeking risk capital. To address this may require **new institutions or bolstering of existing ones**, such as the British Business Bank. And as we have noted these institutions themselves would benefit from being explicit about their purpose. Similarly banks and other financial institutions, their operations underpinned by fiduciary responsibility, and their regulators being explicit about purpose, should offer more consistent long term funding.

As regards regulations and taxes, we have suggested that there may be many opportunities to promote modest changes which can have significant effects; from the calculation of risk weighted assets to the introduction of delayed trades on stock exchanges. Our suggestion is that, rather than a wholesale reform, these small changes could have a profound effect. Indeed unless attention is paid to these issues major reforms may flounder.

But perhaps the most significant effect of moving towards a purposeful financial system will be its effect on stewardship. The reforms we have proposed will tend to discourage the trading of shares, and encourage investors to be more active in the stewardship of companies. For example, when the Hermes Principles were written, they were an explicit attempt to incorporate fiduciary duty into fund management. As part of the exercise of those principles, Hermes undertook to support well run companies facing a hostile takeover. In our workshops, some raised the question of whether the fear of hostile takeovers dissuaded managers from pursuing purpose. In effect Hermes addressed this concern. Within a purposeful system these sort of long term relationships between investor and company might tend to become the norm.

Other Recommendations

There are however certain recommendations in the Policy Paper, where the mechanism for achieving them might merit discussion. Shareholders will be likely to support purposeful companies, as we have noted in Section 4. However they are likely to be concerned about legal changes which involve a loss of accountability. Indeed, if directors cannot be held to account, it may be difficult for companies to raise equity capital, since they have few other contractual rights. There is however considerable progress which could be made towards purpose without changing current laws. We have already noted that Section 172 (1) of the Companies Act requires directors to promote the success of their company for the shareholders "as a whole", as well as having regard to stakeholders. Fiduciary duty would suggest that the shareholders would be millions of individual savers, and stakeholders' interests should also be served. However, this section of the Companies Act is unenforceable since the directors' duty is owed to the company itself. It cannot be used by those whose rights it aims to protect. **Stakeholders and shareholders alike need an affective remedy if the rights they enjoy under the law are abused**. There needs to be some enforcement mechanism. Indeed, many would argue that the directors of companies who have behaved badly (e.g. Sports Direct and BHS) were in breach of the law. Indeed, even if purpose was more explicitly incorporated within company law, it is unlikely to have any effect unless it is enforceable.

Of course, it is perfectly possible under current law to entrench purpose within the companies statutes, if founders, or subsequent shareholders wish to do so. This involves the use of Section 172(2). But this provision is hardly ever used. One way to do so might be to **encourage those private companies which provide public services to adopt the provision offered by Section 172(2)**. This might be a more effective way to ensure they operated in good faith, than creating ever more regulations. This might be particularly germane for utility companies, and other highly regulated industries, including finance. It might help reduce the incentive to get around the regulations and avoid the 'regulatory whack-a-mole' which has come to characterise such industries.

5.4 RECOMMENDATIONS FOR FUTURE ACTIVITY

We are deeply indebted to the British Academy for supporting this work around the purpose of finance. In this paper, we have set out a series of practical recommendations which will help achieve a more purposeful finance industry. These recommendations cover a very broad field, from the way we teach finance, to the duties of finance practitioners; from the terms of reference of regulators, to the design of our financial institutions. We do not believe that this is a comprehensive list. Nor do we believe they will be achieved overnight. However, we do believe that these are practical suggestions, all of which build on existing initiatives which aim to promote a purposeful system.

In particular, we feel that two areas of further work and research stem from this paper. The first might examine what purpose looks like in specific financial institutions—banks, insurers, stock markets and the like--, and that each might seek to define its particular purpose. We note the comments made at the workshop that this would help to provide a further level of granularity of what purpose means within the industry and the actors and institutions within it. The second area is around what model of change might look to drive change within the industry and its various sectors. Within this, an analysis of the likely costs and benefits of each of these recommendations would provide a useful way in which to debate how to create a shift towards a more purpose driven industry.

We hope that this paper will encourage more research, debate and discussion around the purpose of finance. It is desperately needed because at present it is all but absent. A focus on purpose would result in practical changes to our education system, our legal and regulatory environment, and to the practice of finance. We do not pretend that this is a blueprint for perfection. However, it sets a direction. And by taking this path, the financial system will be better able to support the emergence of companies which are truly purposeful We look forward to working with the British Academy in achieving that goal.

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APPENDIX ONE

Through 2017 to 2019 we have held a series of discussion groups with a variety of stakeholders detailed below. These have formed part of our research; asking others how they define “the purpose of Finance?” We have listed these below.

1. Four practitioner focused meetings of approximately 20 members from financial institutions. The majority of those participating have been senior level leaders within these organisations, most of whom are tasked with thinking about the strategic direction and activities of the firms they represent. Some participants represented global financial organisations but the majority have been from the UK, and London based.
2. Larger forums with multiple stakeholders from a variety of industries and roles connected with the Finance industry. In total, we have had around 300 stakeholders attend these forums where our research has been presented and discussed.
3. Various conferences, presentations and panel discussions around the theme of the Purpose of Finance. These have included conferences focussed on responsible investment as well as more general conferences about the Finance industry.
4. Presentations to the Bank of England, and the Financial Conduct Authority.
5. Presentions to the All Party group on Inclusive Growth, and the OECD Parliamentarians Network
6. Academic audiences within the Global research alliance for sustainable finance, Cambridge University, London Business School and within the work stream of the Future of the Corporation at the British Academy.

APPENDIX TWO

Notes on the methodology used for the literature review research.

Our review in 2017 encompassed looking at the following search terms through 'Google Scholar'. We review the literature and the key studies that were found on the following topics in the main body of this paper.

- The purpose of finance
- The function of financial markets
- The existence of financial intermediaries
- The purpose of banks, insurers, and pensions

In 2019, using the above search terms we reviewed this literature, and in addition surveyed the following 10 journals considered to be the highest ranking journals in finance, using the worldcat search engine. The conclusions of our findings are in the main body of this paper.

1. Journal of Finance Published by Wiley. The official publication of The American Finance Association, which publishes English-language research in all areas of finance.

2. The Review of Financial Studies Published by Oxford Academic. Covering both theoretical and empirical work in finance. Argued to cover the most relevant studies in Finance.

3. Journal of Financial Economics Published by Elsevier. Covers the areas of capital markets, financial institutions, corporate finance, corporate governance, and the economics of organizations.

4. Journal of Accounting and Economics Published by Elsevier. Focuses on the interface between economic theory and the practice of accounting.

5. Journal of Financial and Quantitative Analysis Published by Cambridge. Covering theoretical and empirical research, in the topics of corporate finance, investments, capital and security markets, and quantitative methods.

6. Journal of Banking and Finance Published by Elsevier. Covers research on Financial institutions and the system in which they operate

7. Journal of Money, Credit and Banking Published by Wiley. Covers broad areas of money, banking, credit markets, regulation of financial institutions, international payments, portfolio management, and monetary and fiscal policy.

8. Journal of International Money and Finance Published by Elsevier. Covers international monetary economics or international finance.

9. Journal of Business Finance & Accounting Published by Wiley. Covers topics in accounting, corporate finance, and corporate governance.

10. Journal of International Financial Management and Accounting Published by Wiley. Covers international aspects of financial management and reporting, banking and financial services, auditing, and taxation.

APPENDIX THREE

Journal articles and selected additional references reviewed for literature review 2019

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