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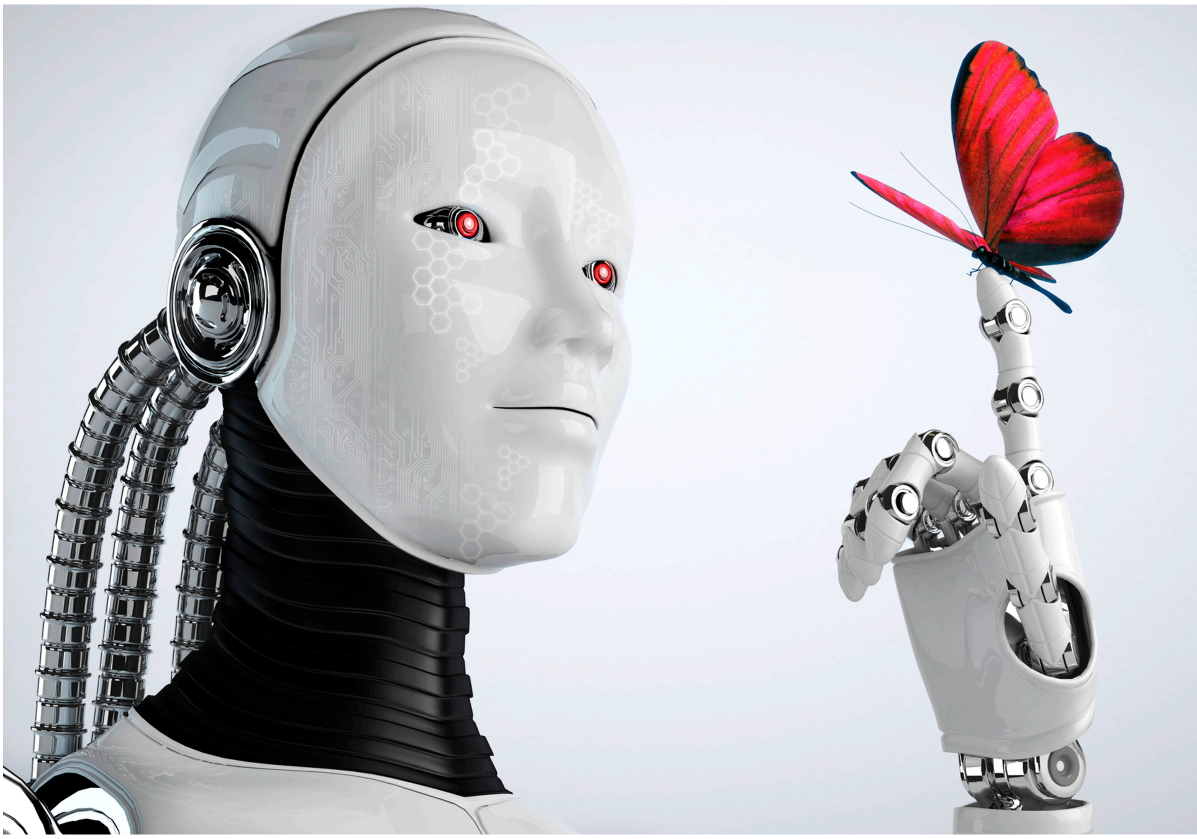

What's the Purpose of Britain? Think Artificial Intelligence and Innovation Capitalism

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There is universal acceptance that the **UK economy is at a critical juncture**. The uncertainties of Brexit compound the challenges of a potential decline in the long run growth rate, the ongoing aftermath of the financial crisis and the disruption to many business models posed by the digital revolution. The UK's trend rate of productivity growth has stagnated since the financial crisis, and the current account deficit has exploded to unsustainable levels. There is an emerging consensus, which the new government has taken on board reversing the stance of its predecessor, that part of the response must be an activist industrial strategy.

Industrial strategy has already proved its worth in the aerospace and automotive sectors – two of the UK's biggest export industries – where government, business and unions agree priorities for state support and private sector investment. But **success means going beyond the way industrial policy is normally understood** – targeted public investment, provision of fiscal incentives and collaboration with the private sector to identify promising sectors. This is the starting point. **The essential extra ingredient is a critical mass of focused, purposed companies** – the equivalents of goal-oriented athletes where the success of UK Sport and the Olympics are often cited as analogous to industrial strategy – to exploit the opportunities that are opened up. The ownership, governance, ecosystem and constitution of companies that can best deliver purpose are thus as critical as the design of the strategy itself. It is neglect of this dimension that has been an important reason why earlier industrial strategy initiatives have had less success than they should. Purposed companies are also those most likely to take their wider societal obligations more seriously – particularly important when business is suffering a crisis of trust.

These challenges – of productivity improvement, of reinvention of our economy in the wake of Brexit, and of building more trust - have a common theme: they require great UK companies showing visionary long term leadership – Purposeful Companies. **Purpose defines a company's aspirational reason for being – who it is and why it exists**. Beyond making a profit, an organization's purpose guides behaviour, influences strategy and transcends leaders. It is the compass that provides direction to achieving sustainable competitive advantage and driving long-term value

Business theorists and practitioners alike have consistently identified the value of strong corporate cultures in overcoming the difficulties of creating the right incentives and overcoming business uncertainties: they are even more important in an age of intangibles (everything from copyright to the algorithms that under mobile apps) where successful value creation requires marshalling and putting vast quantities of knowledge to use that would otherwise be scattered and lie idle. **The opportunities and challenges of digitisation, of artificial intelligence with all the associated ethical issues cross-cutting the enormous possibilities, of the internet of things etc. are best exploited by companies with a strong sense of purpose. Markets which centre on hard-to-value intangibles are continuing to grow at a rapid rate – again best exploited by purposed companies – as are "open innovation" strategies that depend on high trust relationships between companies coming together to co-innovate**. The evidence is that companies who operate in ecosystems that foster great purpose innovate, invest, serve customers and engage employees better than those that do not. **The difficulty is that British companies suffer from an uniquely fragmented, uncommitted shareholder base so that inevitably, abetted by the wider governance, regulatory, legal and incentive framework, immediate financial returns rather than purpose loom disproportionately large in company decision-making.** On the basis of the measurable differences between purposed companies and those who are not, the degree of **foregone value creation could be as high as £130 billion a year**.

A strong domestically owned corporate sector represented in all our major cities, organised around purpose, is a necessary precondition for not only sustained, but spatially balanced growth. More purposed companies are the missing yeast in the policy mix – the issue that is too rarely discussed. **Crucially British companies have fewer anchor, "blockholdings" (shareholdings comprised of investors holding 5% or more of the company) than companies anywhere in the industrialised world. The consequent**

lack of support for purpose and long term value creation has been associated with falling R&D, inadequate investment, and declining levels of public trust. Shareholder interests have primacy over all other stakeholders in UK corporate governance. Without balancing stakeholder rights for, say, creditors or employees in ways we propose below, **boards may be swayed too heavily towards meeting short-term shareholder requirements.**

Measurement of intangibles is poor. Traditional accounting measures of the balance sheet now capture less than half the value of British companies, and stock markets can be poor at valuing intangibles. The lack of widely accepted and measureable indicators relating to innovation and the building of intangible value results in excessive focus on financial value that can be measured. Coupled with a culture of quarterly reporting (although now no longer required) and pay linked to short term success this results in an excessive focus within companies on short-term financial performance.

Company incorporation has become divorced from purpose and the public interest, and as a result directors have no certifiable obligations in relation to the purpose of companies they oversee. British boards have few means to secure shareholder commitment to their purpose, given the insistence in the UK on common rights for all shareholders. Long term and founder shareholders rarely have differential voting rights, directors are easily discarded and takeover is comparatively easy. As a result there is little scope for differentiated shareholding models that can emphasise purpose

With some noteworthy exceptions, the British asset management industry pays only lip service to stewardship obligations, but is overall too fragmented to act as an engaged long-term investor. It has suffered from the decline in influence of traditional British pension fund and insurance company shareholders. Moreover pension fund trustees often lack relevant experience and knowledge to carry out proper performance evaluation, turning to external advisors. A lack of trust between parties means that the mandates tend to be quite restrictive. This is exacerbated by run-away executive pay. As well as being complex, incentive pay is generally too short-term; moreover, these short-term incentives can have a significant effect on behaviour given that it forms as much as three quarters of executive packages. CEOs can earn life-changing sums of money in just a few years. Companies rarely have a coherent approach to pay fairness. **Yet workers' concerns about inequality are largely driven by their concerns about job security and their own living standards.** A coherent approach to rebuilding trust around executive pay also requires initiatives on wider workforce pay.

The Big Innovation Centre's Purposeful Company Taskforce in its interim report published in May has assembled the most extensive evidence base yet for making these judgments – the next task is identifying what to do. There is no single magic bullet, rather a series of initiatives that cumulatively will move the dial. Our ideas are still being worked up – we aim for publication of our final report in February – but they include inviting companies to publish purpose statements in such a measurable way they can be independently certified, a broadened definition of directors fiduciary duties, better reporting of intangibles and creating a stronger template for the incorporation of purposed companies, notably so-called Benefit Corporations, with fiduciary responsibilities to a wider range of stakeholders than shareholders.

To foster more shareholder engagement we suggest a **strengthening of existing stewardship codes, enabling a greater diversity of shareholding structures legislation to allow dual-class share structures including commitment devices to promote shareholder loyalty, such as giving long-term shareholders further financial incentives.** Takeovers should be harder by restricting votes to long-term shareholders. On executive pay we suggest **new guidelines for simplified pay structures within minimum five year periods based on long term equity and debt holdings, to be incorporated into the UK Corporate Governance Code – and extending shareholder powers on pay by triggering a new binding vote regime.** Companies should report on how they address pay fairness through a **Fair Pay Charter covering approach to executive pay and wider employee pay**. Employees should have the **Charter explained to them with their views formally sought.**

Beyond that there is a need to create a vastly enhanced, pooled stewardship capability for UK based asset managers along with more structured access to the information companies hold that can allow the build-up of more block shareholdings to support purposed companies. **The UK should have an independently managed investment fund to provide anchor blockholdings, possibly building on the further proposed consolidation of public pension funds.**

These are embryonic ideas. Any single one would not change things much, but taken together they could begin the transformation of Britain's ownership ecosystem and allow the creation of more purposed companies. **Great companies, committed to open innovation, are the foundations of economic success. It is time to debate how we can create more of them.**

… But is Britain ready?

Will Hutton, Chair
Birgitte Andersen, CEO & CoCreator