Chapter 10

International finance: theory and practice
International financial and equity markets

• Foreign Exchange Market
• Money Markets
  – Structured Investment Vehicles (SIVs) and Derivatives Markets
  – Eurocurrency Markets
  – Euro-paper and Euro Notes Markets
  – Eurobond Markets
  – Futures and Options Markets
• International Equity Markets.
Foreign exchange market

- Where international currencies are traded
- No physical existence
- *Spot rate*: domestic currency price of a unit of foreign exchange when the transaction is to be completed in 3 days
- *Forward rate*: price of that unit when delivery takes place in the future — usually 30, 60 or 90 days.
Spot foreign exchange market

• Generally, the demand for, and supply of, the currency on the international foreign exchange markets will determine the ‘price’ of that currency (i.e. the exchange rate).
Determination of spot exchange rate

Figure 10.1  The foreign exchange market
Change in spot exchange rate

- The initial equilibrium exchange is P in the diagram, with S = D and £Q bought and sold.

- **Depreciation**: anything that increases the supply of sterling or decreases the demand for sterling will cause the exchange rate to fall.

- **Appreciation**: anything that decreases the supply of sterling or increases the demand for sterling will cause the exchange rate to rise.
Forward foreign exchange market

- Forward markets are used by 3 groups:
  - Hedgers
  - Arbitrageurs
  - Speculators.
Hedgers

• Seek to cover themselves (*hedge*) against the risk of exchange variation

• Suppose an importer orders goods to be paid for in three months’ time in dollars, all his/her calculations will be upset if the price of dollars rises between now and the payment date

• He/she can cover himself by buying dollars today for delivery in three months’ time thus locking himself/herself into a rate which reduces the risk element in the transaction.
Arbitrageurs

• Attempt to make a profit on the difference between interest rates in one country and another

• Buy or sell currency forward to ensure that the profit which they hope to make by moving their capital is not negated by adverse exchange rate movements.
Speculators

• Use the forward markets to buy or sell in anticipation of exchange rate changes
• If I think that today’s forward rates do not adequately reflect the probability of the dollar increasing in value I will buy dollars forward, hoping to sell them at a profit when they are delivered to me at some future date.
Exchange rate (1)

- Number of units of the foreign currency needed to purchase one unit of the domestic currency
- Example: £1 = $1.50.
Exchange rate (2)

- At the exchange £1 = $1.50, a £100 export to the US from the UK would have a US equivalent value of $150.
- A $150 import into the UK from the US would have a UK equivalent value of £100.
Changes in exchange rate (1)

- **Fall (depreciation)** Exports cheaper abroad, imports dearer at home
- **Rise (appreciation)** Exports dearer abroad, imports cheaper at home.
Changes in exchange rates (2)

- These can have a significant influence on the competitiveness of exports and imports.
- Example of depreciation (fall) of pound against US dollar
  \[
  \begin{align*}
  £1 &= $2.00 \text{ (2007)} \\
  £1 &= $1.50 \text{ (2009)}
  \end{align*}
  \]
- A £100 export from the UK selling for $200 in the US in 2007 would sell for $150 in 2009.
- A $200 import from the US selling for £100 in the UK in 2007 would sell for £133.33 in 2009.
Types of exchange rate

- Nominal Exchange Rate
- Effective Exchange Rate
- Real Exchange Rate.
Nominal exchange rate

- The rate at which one currency is quoted against any other currency (i.e. *bilateral* exchange rate)
- E.g. £1 = $1.50.
Effective Exchange Rate (EER)

- Weighted average of the bilateral rates against all other currencies (*multilateral exchange rate*)
- Weights determined by the relative contribution of any currency to the total value of trade with the country.
Real Exchange Rate (RER) (1)

• Seeks to measure the rate at which home *products* exchange for products from other countries, rather than the rate at which the currencies themselves are traded.
Real Exchange Rate (RER) (2)

- RER = EER \times \frac{P \text{ (UK)}}{P \text{ (F)}}
  
i.e. RER is equal to the effective exchange rate (EER) multiplied by the ratio of home price $P \text{ (UK)}$ to foreign price $P \text{ (F)}$ products.
  
- If UK prices rise relative to foreign prices, then RER rises since more foreign products can now be exchanged for any given volume of UK products.
### Sterling nominal exchange rates 1997–2007

<table>
<thead>
<tr>
<th>Year</th>
<th>US dollar</th>
<th>Sterling effective exchange rate (2005=100)</th>
<th>Euro</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>1.52</td>
<td>101.15</td>
<td>1.64</td>
</tr>
<tr>
<td>2001</td>
<td>1.44</td>
<td>99.49</td>
<td>1.61</td>
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<tr>
<td>2002</td>
<td>1.50</td>
<td>100.56</td>
<td>1.59</td>
</tr>
<tr>
<td>2003</td>
<td>1.64</td>
<td>96.88</td>
<td>1.45</td>
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<td>2004</td>
<td>1.83</td>
<td>101.60</td>
<td>1.47</td>
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<tr>
<td>2005</td>
<td>1.82</td>
<td>100.00</td>
<td>1.46</td>
</tr>
<tr>
<td>2006</td>
<td>1.84</td>
<td>101.22</td>
<td>1.47</td>
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<tr>
<td>2007</td>
<td>2.00</td>
<td>103.53</td>
<td>1.46</td>
</tr>
<tr>
<td>2008</td>
<td>1.44</td>
<td>73.80</td>
<td>1.03</td>
</tr>
</tbody>
</table>
Credit crunch

• Term widely used to capture the adverse impacts, worldwide, from the collapse of lending by financial intermediaries

• Source often traced to the ‘sub-prime’ markets, i.e. excessive lending to non-credit-worthy borrowers, especially mortgage lending

• Various financial instruments (derivatives) have been closely linked to the ‘liquidity’ problems of banks etc.

Collateralised Debt Obligations (CDOs)

- Packages of debt that split into slices with different risks
- Linkage of slices of these securities with the falling value of mortgages and uncertainty as to how close that linkage is, has undermined the value of these securities in the portfolios of many financial and non-financial intermediaries.
Structured Investment Vehicle (SIV)

- A structured investment vehicle (SIV) exists to help those acquiring it make a profit from the difference between the low cost of short-term debt funding and the higher returns, or yields, of longer term debt investments.

- A SIV consists of a pool of debts of financial companies, such as banks and insurers, including asset-backed securities, or bonds, backed by mortgages, loans or other debt.
Composition of SIV

- The SIV funds these more profitable longer-term investments by issuing debt itself. A small portion of this debt (between 5 and 12%) is longer term and carries the first risk of losses if assets in the pool of investments start to go bad. This debt is also the last to be repaid, but it shares some of the profits made by the vehicle. This is the *junior debt*, otherwise known as the capital notes.

- The lion’s share of debt issued by the SIV is very low cost short-term commercial paper, which has a life span of days or weeks, and medium-term notes, which have a life span of three to six months. This is the *senior debt*. 
Financial instruments and techniques in international trade

- Bills of Exchange
- Forfaiting
- Letters of Credit
- Factoring
- Invoice Discounting
- Securitisation
- Options, Futures and Swaps.
Bills of exchange

- An exporter may send this to an importer ordering the importer to pay a certain sum of money to the exporter on receipt of the bill or at a specified date in the future (often three months).
- The exporter (seller) is the ‘drawer’ of the bill and the importer (buyer) the ‘drawee’, the exporter’s bank is the ‘remitting bank’ and the importer’s bank the ‘collecting bank’.
- The bill of exchange must be ‘accepted’ (endorsed) by the foreign importer (drawee) before it becomes a ‘negotiable instrument’ – once accepted the bill can be sold to a third party for less than the face value (i.e. discounted) if the exporter needs immediate cash or held for the full three months, etc.
Avalised bill of exchange

- Carries a guarantee from the importer’s bank that the bill will definitely be honoured.
- If the bill is not avalised, then the exporter’s bank will expect the exporting company to repay the loan itself should the importer default.
- ‘*With recourse financing*’ is a term used whenever a bank can demand compensation from an exporter should the importer default.
Forfaiting

• For large-scale (and often long-term) finance a company may issue a bundle of bills of exchange, each one maturing on a different date (e.g. six months, 12 months, 18 months, 24 months, etc.) up to the completion of the project.

• Once ‘accepted’, these bills can be sold in their entirety to the company’s own banker should immediate cash be required.
Letters of credit

• These may be required by exporters who wish to have proof that they will be paid before they send their products abroad.
• Such letters are an order from one bank to a bank abroad authorising payment to a person named in the letter of a particular sum of money or up to a limit of a certain sum.
• Letters of credit are not negotiable but can be cashed at the specified bank.
• A ‘confirmed’ letter of credit is one which has been guaranteed by a bank in the exporter’s own country; the confirming bank has no claim on the exporter should there be any default.
• Normally, the exporter is paid by the confirming bank which then collects the money from the foreign bank issuing the credit.
• Almost all letters of credit are ‘irrevocable’, i.e. they cannot be cancelled at any time by the customer (importer).
Securitisation

- The process of converting any existing (non-tradable) loan into a security which is tradable
- The seller of the asset (security) guarantees payment of interest in the new bundled security, which now becomes more liquid than the assets it replaces.
Factoring and invoice discounting

- **Factoring:** Here, the debt is sold on to another company for a price (usually well below the face value of the debt), with the new company now responsible for collecting the original debt.

- **Discounting:** Similar to factoring, except that the exporter retains responsibility for debt collection and for an agreed proportion of bad debts. However, the exporter receives a cash payment (loan) from the invoice the discounter issued to customers.
Futures markets (1)

- A foreign currency futures contract is an agreement to deliver or receive a fixed amount of foreign currency at a future specified time and price.
- The ‘margin requirement’ refers to the price the purchaser of the future foreign currency must pay for others taking the risk of exchange rate volatility.
- Typically, such margin requirements are 5% or less.
- The International Monetary Market (IMM) on the Chicago Mercantile Exchange is the main US market for foreign currency futures. Eurex is the German equivalent and LIFFE (London International Finance and Futures Exchange) is the UK equivalent.
Futures markets (2)

- **Holder** is the purchaser of the option.
- **Writer (or grantee)** is the seller of the option.
- **European options** are those which can only be exercised on the specified expiration date.
- **American options** are those which can be exercised at any time before the expiration date.
- **Premium** is the initially agreed difference between the selling and buying price of the currencies (i.e. the cost of the option to the purchaser).
Futures markets (3)

- Those involved in buying and selling options must negotiate the premium.
- However, the other avenue for gain/loss is the difference between the *exercise* (*strike*) price agreed at the outset and the spot (current) price at the time at which the option is exercised.
- Such options can be traded on formal exchanges or on less formal, over-the-counter (OTC) markets.
- Important formal exchanges include LIFFE in the UK, Chicago Mercantile Exchange and Philadelphia Stock Exchange in the USA, the European Options Exchange in Amsterdam and the Montreal Stock Exchange.
Options markets

- There are obvious similarities between the futures and options markets. The main difference, however, is that the forward and future contracts markets involve a *legal obligation* to buy or sell a fixed amount of foreign currency at a specified point in time (expiration date), whereas the options markets only involve a *right* to such a transaction.
  - A *call option* purchaser has the right to buy foreign currency (sell domestic currency).
  - A *put option* purchaser has the right to sell foreign currency (buy domestic currency).
Eurocurrency market (1)

• Currency held on deposit with a bank outside the country from which that currency originates
• E.g. loans made in dollars by banks in the UK are known as Eurodollar loans
• The Eurocurrency market is a wholesale market and has its origins in the growing holdings of US dollars outside the USA in the 1960s
• Since that time, Eurocurrency markets have grown rapidly to include dealing in all the major currencies, and have become particularly important when oil price rises have created huge world surpluses and deficits, resulting in large shifts in demand for and supply of the major world currencies.
**Eurocurrency market (2)**

- Banks use the market for short-term inter-bank lending and borrowing, to match the currency composition of assets and liabilities, and for global liquidity transfers between branches.
- Markets are also extensively used by companies and by governmental and international organisations.
- Lending is longer term and usually done on a variable-rate basis.
- The market is unregulated, so that banks which are subject to reserve requirements or interest rate restrictions in the home country can do business more freely abroad.
- Margin between the lending and borrowing rates is narrower on this market than on the home market, because banks can operate at lower cost when all business is wholesale and when they are not subject to reserve requirements.
Euro-paper and Euro-note markets

- *Euro-commercial papers* (ECPs) are short-term debt instruments usually denominated in dollars. They can be issued by MNEs with excellent credit ratings, and holders obtain a return by purchasing them at a discount (i.e., paying less than face value at issue and receiving face value on maturity).

- *Euro notes* are short to medium-term debt instruments (up to five years to maturity) which again can be issued by MNEs, but with an interest return (rather than discount) to those holding them to maturity.
Eurobond markets

- Longer-term bonds typically with maturity dates ranging up to 30 years
- A *Eurobond* is underwritten by an investment bank and can be sold only outside the country from which the bond originates
- Eurobonds are usually issued by large MNEs (of high credit standing), governments and international institutions
- The interest paid may be fixed or variable
- Some Eurobonds are ‘convertible’ as holders can convert the bond at a set price (‘warrant’ price) prior to the maturity date
- Less regulation and fewer disclosure requirements than in other bond markets and various tax advantages.
Currency and interest rate swaps (1)

- The IMF introduced (in 1961) the idea of ‘currency swaps’ by which a country in need of specific foreign exchange could avoid the obvious disadvantage of having to purchase it with its own currency by simply agreeing to ‘swap’ a certain amount through the Bank for International Settlements.

- The swap contract would state a rate of exchange which would also apply to the ‘repayment’ at the end of the contract.
Currency and interest rate swaps (2)

- MNEs as well as governments are now making use of swap facilities, with the swaps arranged by dealers located in various international financial centres.
- These can involve both currency swaps and interest rate swaps.
- E.g. one MNE may borrow funds in its own financial market in which it has low interest access to funds and swap these loans with those similarly obtained by another MNE located overseas.
- As well as removing the exchange risk on low-cost borrowings, such swap transactions have the further advantage of not appearing on the firm’s balance sheet! Interest rate swaps can also involve changing the maturity structure of the debt.
- Here, one party to the swap typically exchanges a floating-rate obligation for a fixed-rate obligation.
International equity markets

- Equity refers to shares here
- Non-redeemable assets which buy part-ownership of a company
- Benefits: possible capital appreciation and dividend payment
- Preference versus Ordinary shares.
Strategic financial risk management

- Credit rating agencies important here
- ‘Default risk’: likelihood that the issuer will fail to service (pay interest on) the bonds, as required
- The well-known companies, Moody’s Investors Service and Standard & Poor’s, both based in New York, dominate the ratings industry
- Two smaller firms, Fitch IBCA and Duff & Phelps Credit Rating Co., also issue ratings for many types of bonds internationally
- The firms’ ratings of a particular issue are not always in agreement, as each uses a different methodology.
Importance of credit rating

• A downgrading of the credit ratings of either a private company or government bonds can have serious implications for the issuer.
• Lenders will insist on higher interest rates on any future loans to that company or government in order to cover the increased risks of making such loans.
• This can be important for both individual businesses and for the macroenvironment in which they operate since higher interest rates are likely to depress aggregate demand (both consumption and investment) in the country and increase the prospects of economic recession.
## Credit risk assessments (1)

<table>
<thead>
<tr>
<th>Credit Quality</th>
<th>Moody’s</th>
<th>Standard &amp; Poor’s</th>
<th>Fitch IBCA</th>
<th>Duff &amp; Phelps</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highest credit quality; issuer has strong ability to meet obligations</td>
<td>Aaa</td>
<td>AAA</td>
<td>AAA</td>
<td>AAA</td>
</tr>
<tr>
<td>Very high credit quality; low risk of default</td>
<td>Aa1</td>
<td>AA+</td>
<td>AA</td>
<td>AA–</td>
</tr>
<tr>
<td></td>
<td>Aa2</td>
<td>AA</td>
<td></td>
<td>AA</td>
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<tr>
<td></td>
<td>Aa3</td>
<td>AA–</td>
<td></td>
<td>AA–</td>
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<tr>
<td>High credit quality, but more vulnerable to changes in economy or business</td>
<td>A1</td>
<td>AA+</td>
<td>AA</td>
<td>AA–</td>
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<tr>
<td></td>
<td>A2</td>
<td>AA</td>
<td></td>
<td>AA</td>
</tr>
<tr>
<td></td>
<td>A3</td>
<td>AA–</td>
<td></td>
<td>AA–</td>
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</tbody>
</table>

- **Moody’s**: Aaa = Highest credit quality; issuer has strong ability to meet obligations.
- **Standard & Poor’s**: AAA = Very high credit quality; low risk of default.
- **Fitch IBCA**: AAA = High credit quality, but more vulnerable to changes in economy or business.
- **Duff & Phelps**: AAA = Highest credit quality; issuer has strong ability to meet obligations.
Credit risk assessments (2)

<table>
<thead>
<tr>
<th>Moody’s</th>
<th>Standard &amp; Poor’s</th>
<th>Fitch IBCA</th>
<th>Duff &amp; Phelps</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adequate credit quality for now, but more likely to be impaired if conditions worsen</td>
<td>Baa1</td>
<td>BBB+</td>
<td>BBB+</td>
</tr>
<tr>
<td>Baa2</td>
<td>BBB</td>
<td></td>
<td>BBB</td>
</tr>
<tr>
<td>Baa3</td>
<td>BBB–</td>
<td></td>
<td>BBB—</td>
</tr>
<tr>
<td>Below investment grade, but good chance that issuer can meet commitments</td>
<td>Ba1</td>
<td>BB+</td>
<td>BB+</td>
</tr>
<tr>
<td>Ba2</td>
<td>BB</td>
<td></td>
<td>BB</td>
</tr>
<tr>
<td>Ba3</td>
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<td>BB–</td>
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### Credit risk assessments (3)

<table>
<thead>
<tr>
<th></th>
<th>Moody's</th>
<th>Standard &amp; Poor's</th>
<th>Fitch IBCA</th>
<th>Duff &amp; Phelps</th>
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</thead>
<tbody>
<tr>
<td>Significant credit risk,</td>
<td>B1</td>
<td>B+</td>
<td>B</td>
<td>B–</td>
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<tr>
<td>but issuer is presently</td>
<td></td>
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<td>able to meet obligations</td>
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<td></td>
<td>B2</td>
<td>B</td>
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<td>B</td>
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<tr>
<td></td>
<td>B3</td>
<td>B–</td>
<td>B–</td>
<td>B–</td>
</tr>
<tr>
<td>High default risk</td>
<td>Caa1</td>
<td>CCC+</td>
<td>CCC</td>
<td>CCC</td>
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<tr>
<td></td>
<td>Caa2</td>
<td>CCC</td>
<td>CC</td>
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<tr>
<td></td>
<td>Caa3</td>
<td>CCC–</td>
<td>C</td>
<td></td>
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<tr>
<td>Issuer failed to meet</td>
<td>C</td>
<td>D</td>
<td>DDD</td>
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<td>scheduled interest or</td>
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</table>
# National credit ratings

<table>
<thead>
<tr>
<th></th>
<th>Greece</th>
<th>Portugal</th>
<th>Spain</th>
<th>Ireland</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sovereign credit rating (S&amp;P)</strong></td>
<td>A -</td>
<td>A +</td>
<td>AA +</td>
<td>AAA</td>
</tr>
<tr>
<td><strong>Current account deficit (% of GDP)</strong></td>
<td>14.5</td>
<td>10.9</td>
<td>9.7</td>
<td>6.2</td>
</tr>
<tr>
<td><strong>Budget deficit (% of GDP)</strong></td>
<td>2.8</td>
<td>2.2</td>
<td>1.5</td>
<td>5.6</td>
</tr>
<tr>
<td><strong>Government debt (% of GDP)</strong></td>
<td>93.0</td>
<td>64.5</td>
<td>37.8</td>
<td>29.7</td>
</tr>
</tbody>
</table>
Strategic risk management

- Methods of implementing such a policy include:
  - Modifying the company’s operations
  - Adjusting the company’s capital structure
  - Employing targeted financial instruments
  - Combining the above 3 methods to minimise the aggregate net exposure to risk from all sources.
Figure 10.3  Alternative risk transfer (ART)
Centralised financial management

Reasons in favour

• Minimising cost/maximising return
• Flexibility
• Scale economies
• Professional expertise
• Synchronisation.
Decentralised financial management

Reasons in favour

• Generality
• Motivation and morale
• Conflicts
• Inflexibility.
Reasons for different accounting standards

- The legal system
- Types of ownership patterns
- The accounting profession
- Conservatism.
Shareholder ratios

- *Earnings per share* (EPS)
  - Net profit after tax
  - Number of ordinary shares

- *Price/earnings* (P/E) Ratio
  - Share price
  - Earnings per share

- *Dividend yield*
  - Dividend per share \( \times 100\% \)
  - Market price per share
Profitability ratios

- **Gross Profit Margin**
  \[
  \text{Gross profit} \times 100\% \quad \text{Sales}
  \]

- **Return on Capital Employed (ROCE)**
  \[
  \text{Operating profit} \times 100\% \quad \text{Capital employed}
  \]
Activity ratios

• *Stock Turnover*
  \[
  \text{Stock} \times 365 \text{ days} \div \text{Sales}
  \]

• *Debtor Turnover*
  \[
  \text{Debtors} \times 365 \text{ days} \div \text{Sales}
  \]
Liquidity ratios

- **Current Ratio**
  
  Current assets
  
  Current liabilities
  
  i.e. \( \text{Stocks} + \text{Debtors} + \text{Cash} \)
  \( \text{Overdraft} + \text{Creditors} + \text{Taxation} + \text{Dividends} \)

- **Quick Assets (Acid Test) Ratio**
  
  Current assets – Stock
  
  Current liabilities
Gearing ratio

- Measures reliance on borrowings

\[
\frac{\text{Long-term loans}}{\text{Capital employed}} \times 100\%
\]
Accounting conventions

- Objectivity
- Separate entity
- Money measurement
- Historic cost
- Double entry.
Annual report

• Chairman’s statement
• Director’s Report
• Profit and Loss Accounts, Balance Sheet and Cash Flow Statements
• Notes to the Accounts
• Auditor’s Report.
Profit and loss account

- Gross profit: £60
- Less expenses: £25
- Operating profit: £35
- Add non-operating income: £10
- Profit before interest and tax (PBIT): £45
- Less interest: £4
- Profit before tax: £41
## Balance sheet

<table>
<thead>
<tr>
<th></th>
<th>£m</th>
<th>£m</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fixed assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land + buildings</td>
<td>50</td>
<td></td>
</tr>
<tr>
<td>Machinery + vehicles</td>
<td>4</td>
<td>54</td>
</tr>
<tr>
<td><strong>Current assets</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stock</td>
<td>26</td>
<td></td>
</tr>
<tr>
<td>Debtors</td>
<td>6</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>4</td>
<td>36</td>
</tr>
<tr>
<td><strong>Less: current liabilities</strong></td>
<td>(26)</td>
<td></td>
</tr>
<tr>
<td><strong>Net current assets (working capital)</strong></td>
<td>10</td>
<td></td>
</tr>
<tr>
<td><strong>Assets employed</strong></td>
<td>64</td>
<td></td>
</tr>
</tbody>
</table>
Higgs Committee Report (2002)

Sought to improve corporate governance in the UK by recommending that:

- At least 50% of a company’s board should consist of independent non-executive directors
- Rigorous, formal and transparent procedures should be adopted when recruiting new directors to a board
- Roles of Chairman and Chief Executive of a company should be separate
- No individual should be appointed to a second chairmanship of a FTSE 100 company.