



# **Institutional investment in the UK 6 years on**

## **PIRC's Response to the NAPF Discussion Paper**

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## Introduction

We welcome the opportunity to respond to the consultation on implementation of the Myners Principles. Pensions & Investment Research Consultants Ltd (PIRC) has been an independent adviser to pension funds and other institutional investors for over 20 years. PIRC's clients have combined assets in excess of £750 billion and include some of the largest pension funds, investment management companies and insurance companies in the UK and overseas. Together, they comprise a diverse group of institutional investors with long-term liabilities and broad fiduciary duties.

PIRC undertakes company research on corporate governance and corporate social responsibility issues at public companies, and provides advice to clients on proxy voting strategies and other active shareholder initiatives. Our comments are based on two decades of practical experience, which inform our views on the strengths and weaknesses of disclosures, governance structures, and the interaction of statute, regulation and codes of practice.

We have only commented on those areas of the consultation paper where we have particular views and expertise.

### Questions for Discussion

The questions posed in the text are listed here again for convenience:

#### Question 1:

Six years on from the Myners Report, what are the key issues in pension scheme governance and the efficiency of investment decision-making?

**We believe that strengthening the knowledge, competence and powers of lay trustees is the major challenge facing regulators, Government and active trustee boards. The Myners' Principles were a great start to this admittedly long term process but now need to be further supplemented by a range of new measures, some of which we outline below.**

#### Question 2:

What are the implications of the transformed pensions environment compared with 2001 for the Myners approach of voluntary 'comply-or-explain' Principles and the relevance of the Principles themselves?

**One of the most important changes that has taken place between 2001 and today's pensions environment is the profound loss of confidence that ordinary people (pensions contributors and non-contributors) have in the UK pensions system. The systematic undermining of defined benefit occupational pension provision by employers, parts of the financial sector**

**and often the inadvertent consequences of Government action has created a much more complex and vulnerable occupational pensions sector in which the Principles now have to be implemented and developed.**

**Question 3:**

In the light of experience, what additional Principles might be added or how might the existing Principles be further amended?

**We believe that a principle on trustee training would be appropriate to add to the list of Myners' Principles.**

**Question 5:**

What governance issues are raised by the shift from DB to DC pension provision (and increasingly contract-based DC schemes)? Are these issues different from those raised by Myners in 2001?

**PIRC believes that the shift from DB to DC, and from trust-based to contract-based provision, provides significant challenges to the governance of pension schemes. We are not convinced that contract-based provision is suitable for anything other than small firms, as there is no formal governance structure comparable to a trustee board and as such oversight is weak, if not non-existent.**

**We also believe it is critical that the proposed Personal Accounts system is developed in a way that is comparable to an occupational DC scheme. It should also be compliant with the Myners principles.**

**Question 6:**

What is your perception of the extent of compliance with the Myners Principles by pension funds since their publication in 2001 and the Government's review of progress in 2004?

**PIRC believes that there has been broadly good progress towards the implementation of the Principles. However we believe that it has been weak in some areas such as shareholder engagement and stewardship. In particular compliance amongst private sector occupational schemes has been very limited, and the extensive delegation to fund managers is in our view poorly monitored.**

**Question 7:**

What evidence have you of changes in behaviour and practice as envisaged by the Principles in your own organisation or through surveys conducted by your organisation, or those you represent.

**Many of our pension fund clients have adopted a regular compliance monitoring report format for annual review, and some for quarterly review by trustees.**

**Question 8:**

Given the evidence on progress to date, do you see a need for moving further beyond the voluntary approach? What would be the advantages and disadvantages of moving further beyond the voluntary approach?

**We believe that the Principles are the most important set of best practice guidance any pension fund trustees could adopt for improving the management and stewardship of their pension scheme's assets. As such we wholly support the introduction of the ICR proposal attached to this consultation document.**

**Question 10:**

Are the 2004 Pensions Act requirements on trustee knowledge and understanding appropriate?

**PIRC believes that the TKU requirements outlined in the Act, and developed by the Pensions Regulator, have already had a significant impact in improving the governance of pension schemes.**

**Question 12:**

Do you agree that trustees should set out in writing their collective beliefs, as a 'sheet anchor' to their investment approach?

**PIRC believes that encouraging trustees to articulate their investment beliefs could be a useful additional element in the formation of pension fund investment strategies. It might even be a necessary step where trustees are, for example, seeking to develop genuinely long-term investment approaches.**

**Question 19:**

- (a) Do you agree with the assessment of progress on Principle 5 (explicit mandates)? Has behaviour and practice changed as envisaged by the Principle?
- (b) What evidence do you have from your own organisation (or from those you represent) that behaviour and practice has changed, for example from survey data or other activities?
- (c) Given the changes in the pensions environment since 2001, is Principle 5 (explicit mandates) still appropriate?
- (d) What changes to this Principle (if any) would be desirable to improve governance and investment decision-making by trustees?

**We do not accept the consultation paper's assertion that progress on this principle has been significant with respect to investment time horizons. In PIRC's experience many trustees continue to be focused on investment performance, and indeed this is the one issue that routinely appears on the agenda of trustee meetings. We believe that it is important for trustees to consider manager performance, but we are not convinced that it should feature so centrally in trustee decision-making. The manner in which performance statistics are provided does not help. We do not believe that a single quarter's performance has much importance in the context of a typical mandate, yet trustees are routinely provided with quarterly statistics. In addition few trustees have had training in how to interpret statistics and as such will almost certainly make mistakes.**

**We believe that the culture around mandates continues to have a very strong focus on performance. We note that the joint research that was carried out by the NAPF and IMA found differences in the perceptions of trustees and fund managers about the nature of mandates and the potential for this to encourage short-termism. The research found that 70% of NAPF members review fund manager performance either quarterly or monthly (although the overwhelming majority of this 70% have reviews on a quarterly basis). Trustees also put performance at the top of the list of issues they monitor fund managers on.**

**Some of the research carried out in support of the implementation of the Myners Review reinforces the message that there are performance pressures on fund managers coming from their pension funds clients. A DWP study found that almost a third of schemes gave investment managers 12 months or less to achieve performance targets.**

**Further research by the TUC found that trustees overwhelmingly felt they should be able to terminate mandates early for poor performance. In addition the specialist financial press to which trustees have access has a very strong reliance on performance stories, with mandate "hires and fires" being a staple of much coverage.**

**Taken together such factors can only create an environment in which performance is something which trustees feel they must constantly monitor and manage, and that underperformance is something that needs to be dealt with. Inevitably, 'doing something' about underperformance will often mean terminating mandates, even though this may not have the result that trustees are expecting. We believe this in turn must have some impact on the decision-making of fund managers.**

**One option that may be worthy of consideration is developing trustee training which explores both how to interpret data, and the nature of investment performance (ie the tendency of active managers' performance to be mean-reverting).**

**Question 21:**

(a) Do you agree with the assessment of progress on Principle 6 (shareholder activism)? Has behaviour and practice changed as envisaged by the Principle?

(b) What evidence do you have from your own organisation (or from those you represent) that behaviour and practice has changed, for example from survey data or other activities?

(c) Given the changes in the pensions environment since 2001, is Principle 6 (shareholder activism) still appropriate?

(d) What changes to this Principle (if any) would be desirable to improve governance and investment decision-making by trustees?

**PIRC does not agree with the assessment of progress in the consultation document. We believe there are important areas where further improvements could be made. It is true that a number of fund managers have increased the level of resources they devote to corporate governance and shareholder engagement. Managers have also become better at reporting to clients, although most still baulk at reporting activity publicly.**

**We also know of the remarkable reluctance of some fund managers to provide sufficient disclosure of their activism to their own client pension funds. We have witnessed several instances where fund managers have refused to divulge what issues have been raised with which companies and where engagement has been left.**

**We believe that progress by pension funds has been even more patchy. A handful of the biggest funds, such as USS and Railpen, are reasonably active, as are many of the local authority funds grouped in the LAPFF. However we believe that most corporate funds do little.**

**Research suggests that the overwhelming majority of schemes delegate responsibility for shareholder engagement to their fund managers. However although some surveys suggest that trustees regularly read the**

reports that fund managers make on voting and engagement, fund managers themselves report little feedback from clients. Anecdotal evidence from corporate governance staff in the investment industry suggests that this makes it harder to defend the allocation of resources to engagement activity. The trustee guide published by the LAPFF identifies best practice questions for pension scheme trustees to ask their fund managers on engagement (Delegating Shareholder Engagement: Holding Fund Managers to Account, <sup>1</sup>)

PIRC's assessment therefore is that although some fund managers have improved their 'performance' on activism, in practice engagement is still rather limited, and oversight by pension funds of the activities of their appointed managers is weak. We do not believe that the solution is to require further reporting. Rather we believe that trustee boards should be required to carry out a regular review of engagement, in the context of their annual review and amendment of their SIP statements. This requirement need not be overly prescriptive since there should be flexibility for schemes. However we believe that a requirement for an annual review would focus trustee attention on the issues. In addition it would ensure that fund managers know that their clients will review performance. In addition we strongly support the proposal for a 3 year independent review of Myners' compliance, which would include assessment of progress in this important area.

We strongly believe that the principle is still appropriate. As such we consider that its proper implementation should be a priority.

**Question 25:**

The framework to provide an independent compliance review (ICR) of progress against the Myners Principles is published here for the first time (Appendix 3). Would this framework be the most efficient way of monitoring progress? What are your responses to the questions in Appendix 3, on which comments are invited?

**PIRC strongly supports the recommendation to introduce an independent compliance review, and we note that this recommendation has received strong endorsement in a poll carried out by industry magazine Professional Pensions.**

**We believe that although the industry has made significant progress in the implementation of the Myners Principles there is still work to be done. Therefore the proposed ICR would be a 'light touch' method for encouraging trustees to ensure that they are both aware of their level of compliance and have an incentive to improve and that this is transparent to**

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<sup>1</sup> Cf: [http://www.lapfforum.org/pubs/trustee\\_guides/Shareholder%20Engagement-1.pdf](http://www.lapfforum.org/pubs/trustee_guides/Shareholder%20Engagement-1.pdf)

**their members and key stakeholders. Such an independent review provides a benchmark for comparative analysis for regulators and scheme members. We also believe that a three year requirement is appropriate, and that the results of such an ICR should be audited by the scheme auditors.**

**We believe that costs outlined in the partial Regulatory Impact Assessment are reasonable.**

**Question 27:**

Are there any other general points you would like to raise on:

- the issues raised in this report; or
- institutional investor governance that are not covered elsewhere in this Discussion Paper?

**PIRC believes that the Government should consider a formal review of fiduciary duty and what it entails for all parties involved in pension fund investment. Too often in the past a lack of knowledge or misunderstanding of fiduciary duty has acted as a brake on trustee decision-making. We note the Freshfields Bruckhaus Deringer analysis<sup>2</sup> for the UN Environment Programme Finance Initiative has attempted to bring some much-needed clarity to this area.**

**However, anecdotal feedback from trustees suggests that there is still much confusion, and there is no clear definition for trustees to turn to. A formal review of fiduciary duty, and statement of what it does and does not encompass, is therefore long overdue.**

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<sup>2</sup> *'A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment'*, UNEP FI & Freshfields Bruckhaus Deringer