PENSIONS AND LIFETIME SAVINGS ASSOCIATION

11th June 2018

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Paul Bannister
Department for Business, Energy and Industrial Strategy
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Dear Mr Bannister,

PLSA RESPONSE: DEPARTMENT FOR BUSINESS, ENERGY AND INDUSTRIAL STRATEGY – INSOLVENCY AND CORPORATE GOVERNANCE

We welcome the opportunity to feed in to your consultation on insolvency and corporate governance. The Pensions and Lifetime Savings Association (PLSA) is the voice for pensions and lifetime savings in the UK, representing over 1,300 pension schemes with just over £1 trillion in assets under management and over 400 supporting businesses – including asset managers, investment consultants and other services providers. Our purpose is to help everyone achieve a better income in retirement.

INTRODUCTION

Pension funds represent approximately 60% of the institutional investment money managed in the UK. As owners of capital with long-term time horizons, pension funds are ideally placed to act as stewards of their assets; by ensuring that the long-term performance of investee companies is maximised and firms are run in line with corporate governance best practice, the value of scheme members' retirement savings can be protected and enhanced.

There is a clear relationship between good corporate governance and good outcomes for pension scheme members and we welcome the government's commitment to look at this more closely in light of the recent failures of BHS and Carillion. The PLSA has consistently highlighted the importance of effective corporate governance to long-term investors and plays a key role in the industry in supporting pension schemes to hold companies to account on issues such as executive remuneration, disclosure on workforce culture and practices, and climate risk. Asset owners, including pension funds and insurers, have a unique and important role in drawing stewardship through the investment chain and the PLSA provides both guidance (through our

annual Voting Guidelines[1] and corporate governance policy work) and also opportunities for collective engagement by pension funds with companies on key issues.

It is also important that when a company is in financial difficulties and considering entering insolvency, the interests of all creditors are taken into account in decisions. We welcome the government's commitment to reforming the current system in light of recent events as highlighted both through its recent Defined Benefit (DB) Green and White Papers and the current BEIS paper on insolvency and corporate governance.

We have fed in separately to the Department for Work and Pensions' (DWP) papers on reforming the current DB system, including on the suggest changes to the powers of The Pensions Regulator (TPR). We would urge the government to take a holistic and long-term view when considering how to improve corporate governance and the protection of DB scheme members in the UK; the UK corporate governance regime – although it can be improved – is globally well-regarded and UK institutional investors have a good track record of engaging with the companies they invest in with an eye to the best possible long-term performance. It is important to have a clear understanding of not just the fact that recent high-profile corporate failures occur infrequently, but also of the appropriate roles and function of shareholders and their responsibilities as stewards, the framework around Directors' duties and those bodies which are best equipped to deal with specific concerns around the interests of pension scheme members such as TPR.

RESPONSE

Sales of Businesses in Distress

Q1. Do you think there is a need to introduce new measures to deal with the situation outlined?

Q2. Should the new measures be limited to the sale of a subsidiary or should a new measure extend to any act procured by the parent (through its directors) which operates to the prejudice of the creditors of the subsidiary once that subsidiary is insolvent? Might such measures create material conflicts for directors? If so, how might they be resolved?

Q3. Should the target be the parent company directors responsible for the sale? If not, who else should be targeted; or who in addition?

Q4. How can we ensure that there is no impact on sales which genuinely seek to rescue distressed business, or bring new investment into distressed businesses?

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[1] www.plsa.co.uk/Policy-and-Research/Stewardship/Corporate-Governance-Policy-Voting-Guidelines

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It is vital that company Directors take a full and proper account of their duties both at the point of – and in the run-up to – insolvency as well as more generally. We believe that S.172 of the Companies Act 2006 provides the best framework for Directors' duties in this regard, as it states that a director of a company must "have regard (amongst other matters) to -

(a)the likely consequences of any decision in the long term,

(b)the interests of the company's employees,

(c)the need to foster the company's business relationships with suppliers, customers and others,

(d)the impact of the company's operations on the community and the environment,

(e)the desirability of the company maintaining a reputation for high standards of business conduct, and

(f)the need to act fairly as between members of the company."

We believe that the recent government and Financial Reporting Council (FRC) initiatives to reporting on s.172 compliance could be an effective way of ensuring shareholders and others can hold Directors to account for any failure to comply with their duties in this area – both at the point of insolvency and more generally. We also think that a more effective enforcement regime – including sanctions – for Directors who fail to comply with their duties would also be helpful; we look forward to exploring this further with the FRC in future discussions on the Corporate Governance code and other related policy initiatives.

Although the role of Shadow Directors was not specifically referenced in the government's paper, it is worth explicitly highlighting their role. There has been a general tightening of rules and greater transparency in this area recently and we believe these are positive steps which will aid the Insolvency Service and other government bodies and regulators in considering where liability lies for a given corporate decision or transaction.

The role of TPR

Recent high-profile corporate failures have shone a light on poor corporate governance and its impact on some companies' DB pension schemes due to as the balance of expenditure on dividends, corporate investment and pension scheme funding. Although we believe that generally UK employers do acknowledge the needs of the pension scheme when considering

expenditure decisions[2], we welcome the government's commitment to ensuring greater security of member benefits in its broader programme of work. However, we do not believe that extending Directors' liabilities is the best way to do so – in part because we are concerned that the broader consequences could act as a disincentive for individuals to take on directorships, as well as encourage a disproportionate risk aversion amongst existing company directors when considering whether to enter insolvency – which can appear a less 'risky' course of action than pursuing a possible 'rescue'.

Instead, there should be a greater focus on *enforcing* Directors' duties in respect of s.172, including an appropriate sanction regime. This would fit in the new reporting requirements on company directors' compliance with s.172 duties which should ensure shareholders and other relevant stakeholders have better visibility earlier of any poor corporate behaviour, especially of the kind which is likely to lead to adverse changes in a firm's future financial outlook. Most firms do not become financially stressed overnight and there needs to a framework which supports shareholder, regulatory and policymaker intervention at the first warning signs.

Such changes should sit alongside proposals made by the Government elsewhere regarding TPR's information-gathering powers and its increased capacity for earlier intervention. We also think that there will be a role for TPR to use the data it has gathered to support the work of other regulators and policymakers such as The Insolvency Service in specific cases. We look forward to feeding in further on this point in our response to the forthcoming consultations which follow on from the DB White Paper.

<u>Value Extraction Schemes</u>

Q5. Are new tools needed to enable insolvency office-holders to better tackle this behaviour? Or could existing antecedent recovery powers be expanded to ensure this behaviour is tackled?

Q6. Do you agree the Government should introduce a value extraction scheme reversal power as outlined above? Do you agree that the insolvency test in the current powers is not appropriate in the circumstances outlined above?

Q7. Could the proposal adversely affect the availability of finance for distressed companies? Could it have other adverse effects? If so, how might the proposal be modified to mitigate these effects? Are there any protections that should be given to investors?

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[2] This is partly based upon member feedback, but there is also an argument that s.172 encourages Directors to pursue actions which support the long-term success of the organisation and that doing so in turn results in a greater ability to fund the DB pension scheme.

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Q8. How could the proposal be developed to ensure that only those schemes which unfairly extract value and harm the interests of other creditors can be challenged by the insolvency office holder? Should concepts such as "unfair" and "excessive" be defined or left to the courts to develop through case law?

N/A

<u>Dissolved Companies</u>

Q9. Do you agree that there is a problem in this area and that action should be taken to prevent directors from avoiding liabilities and scrutiny by dissolving their companies?

Q10. Do you agree that director conduct in a dissolved company should be brought within the scope of the Secretary of State's investigatory powers?

N/A

Strengthening Corporate Governance in Pre-insolvency Situations

Q11. Are stronger corporate governance and transparency measures required in relation to the oversight and control of complex group structures? If so, what do you recommend?

For investors to be able to meaningfully act as stewards of their assets, it is vital that they have a clear understanding of investee companies' structures, governance arrangements and strategy. In order to do so, there need to be improvements in how and when such information is communicated to investors. Although we would not support an overly prescriptive approach, the emphasis should be on encouraging companies to display information in a clear and meaningful way through the use of organograms and provision of the appropriate narrative information which links the structure to the governance arrangements and explains the impact on strategy and risk management.

We also believe that there is a greater possible role for the FRC to enforce certain audit requirements. For instance we understand that the requirement for a company's Auditor to consider the Books and Records of any audited company in a way which ensures the company can account accurately for its position not just at year end, but at any point throughout the year, is not followed or enforced stringently. Applying this approach more rigorously could yield benefits when it comes to supporting shareholders and other stakeholders in identifying challenges at a particular firm.

Q12. What more could be done through a revised Stewardship Code or other means to promote more engaged stewardship of UK companies by their investors, including the active monitoring of risk? Could existing investor initiatives to hold companies to account be strengthened (e.g. through developing the role of the Investor Forum)? Could better arrangements be made to ensure that lessons are learned from large company failings and controversies?

We believe that it is neither feasible nor desirable for investors to bear the full responsibility for the behaviour of UK firms. Shareholders' stewardship work in this area must function alongside a robust framework around Directors' duties – including an appropriate sanction and assurance regime – and the work of TPR in providing an effective oversight approach which supports pension schemes in negotiations with their employers.

However, we strongly believe that pension schemes must be active stewards of their investments and engage closely with the companies they invest in. Good stewardship is a fundamental part of trustees' fiduciary duty, helping schemes to protect value and maximise long-term returns for scheme members.

We survey our membership each year to better understand pension funds' approach to stewardship and also encourage asset manager signatories to the Stewardship Code to complete a PLSA 'Stewardship Disclosure Framework' which we publish on the website for members to help them gain an insight into the stewardship policies of prospective managers. Although voting is only one component of stewardship, each year we publish an updated Corporate Governance policy and accompanying Voting Guidelines to highlight the key issues for schemes; in 2018, for instance, our guidelines were updated to reflect recent developments on climate risk.

The Stewardship Code

The PLSA strongly supports the Stewardship Code, as well as the ISC Principles which preceded it. Pension schemes have historically made a material contribution to the Code's formulation and have a unique role in encouraging the Code's adoption – as well as good stewardship more generally – by the asset management industry.

The Code has been a helpful innovation, as demonstrated by its replication in countries such as Denmark and Japan. We have also supported the recent introduction of a tiered structure, which we believe has been important in encouraging better engagement practices and enabling pension schemes to understand who has been undertaking substantial stewardship and who has not, and to incorporate this information into their manager selection decisions. We look forward to working with members to engage with the forthcoming Stewardship Code consultation,

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For stewardship to remain meaningful, investors must be allowed the flexibility to decide which approach to take and on which issues. Anything more prescriptive runs the risk of turning stewardship into a box-ticking exercise. We therefore believe that the Stewardship Code should retain its high-level and principles-based approach.

Asset owners and collaborative engagement

Asset owners have a uniquely influential role when it comes to meaningful stewardship, providing the commercial incentive for their asset managers to undertake activities in this area. Although many of the largest schemes have specific resource allocated to engagement activities (or ensuring their asset managers undertake engagement on their behalf), more could be done to encourage small to medium-sized asset owners to act as stewards.

One powerful form of engagement is for investors to join with others to boost their 'voice' on certain issues. The PLSA has previously brought together representatives of smaller pension funds, asset managers and key investee company executives to have an open and honest discussion about the firm's approach to issues such as climate risk or executive remuneration. We believe that there is value in providing an accessible forum for asset owners to become directly involved in engaging with investee companies. We think this is a useful tool in encouraging asset owners to engage as well as raising awareness of the importance of stewardship to trustees' fiduciary duties. We will continue our work in this area in the context of the new reporting requirements being (or likely to be) placed upon pension schemes by initiatives including the Shareholder Rights Directive, IORP II and the forthcoming DWP investment regulation changes in response to the Law Commission's reports on social and ESG investment.

In addition to the incentives for better and more meaningful stewardship created by recent changes to the Stewardship Code, new reporting requirements and collaborative engagement vehicles, we think that the new generation of younger savers brought into retirement savings forums by auto-enrolment should naturally encourage DC pension schemes to become more active stewards of their assets. Research demonstrates that younger generations are more likely to want to see their values reflected in the design of their pensions and savings vehicles[3]; there is therefore a powerful motivation for DC schemes to think about – and communicate to members, in order to encourage engagement – the role they play in acting as good stewards of capital as part of their long-term approach to investment.

[3] See Bloomberg's 2017 *Impact Report*,the annual Good Money Week survey by UKSIF/YouGov, or PwC's Social Investment Demand research (December 2016).

Pensions and Lifetime Savings Association is the trading name of the National Association of Pension Funds Ltd, a company registered in England and Wales with company number 1130269.
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The role of Investment Management Agreements (IMAs)

An Investment Management Agreement (IMA) documents the relationship between an investor – i.e. a pension scheme's trustee board – and the manager it has selected to manage its assets. Although the manager invests the pension scheme's money on behalf of the trustee, within agreed parameters, the manager has discretion to acquire and dispose of investments without further reference to the trustees.

These parameters are usually included in the "Investment Guidelines" included in an IMA and set out what the investment objectives are that the trustees want the manager to achieve, the strategy to achieve these objectives and the restrictions that the asset manager needs to adhere to when investing the scheme's assets. The Investment Association produces a standard-form IMA which can be tailored by applying or dis-applying certain sections. The PLSA (together with CMA McKenna) has previously produced guidance[4] for trustees around the IMA to help them understand which issues to consider when designing/drafting an IMA.

IMAs are important documents in delineating the scope of the pension scheme – asset manager relationship and setting out a scheme's expectations in terms of asset manager activities. We believe that further work needs to be done on supporting trustees to draft their IMAs in a way which helps them hold their asset managers to account on stewardship issues. We believe that the ICGN (International Corporate Governance Network)'s work in this area on model mandates provides some useful insights.

The role of a 'stewardship oversight group'

Although we believe that there are often a number of lessons to be learned from high-profile corporate failures, we do not believe that it would be useful to create an additional specific body and programme of work, given the significant number of regulatory and policymaker initiatives that naturally get set up in the wake of high-profile corporate scandals.

Instead, we think that lessons could be learned from TPR's approach in respect of their section 89 powers. TPR publishes information on cases where it has "exercised or considered exercising" its powers. It does so in order to ensure everyone has a greater understanding of how it exercises its statutory functions and to provide guidance to regulated firms and help them improve practices, behaviours and compliance with their legal obligations. We believe that there could be merit in a similar approach undertaken by the relevant regulatory bodies in light of corporate failings. This could include case studies of good and bad practice on a variety of related issues, such as on when and how Directors failed to comply with their s.172 duties and

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www.plsa.co.uk/portals/0/Documents/0430_the_napf_guide_to_investment_management_agreetments_march_2015.pdf

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the consequences this had. This would help company directors better understand the expectations placed upon them.

Q13. Do you consider reforms are required to the legal, governance and technical framework within which companies determine dividend payments? If so, what reforms should be considered? How should they be targeted so as not to discourage investment?

Asset owners have a fiduciary duty to act in members' best interests. This includes protecting the value of beneficiaries' capital and maximising financial returns. The return that pension funds get from dividend payments is a key part of this.

However, asset owners also – as stated above – have an interest in the long-term success of the investee company. Key metrics which could be used to judge the future financial (and reputational) health of a firm could include the ratio of dividend payments to capital expenditure or payments to employees. We think that greater disclosure by companies of information such as the metrics highlighted above at key points (such as before voting on the resolution which seeks shareholder approval of the final dividend) could be helpful to investors.

We also note the issue of interim dividends – which are usually decided solely by the directors, without the need for shareholder approval – and the growing trend for companies to pay only interim dividends and thus effectively never bringing a final dividend to investors for approval. We hope that greater attention will be paid to this issue.

Q14. There are perceptions that some directors may not be fully aware of their duties with regard to commissioning and using professional advice. Do you agree, and if so, how could these be addressed?

We believe it is clear that Directors have a duty not to rely purely on their advisers when making decisions, instead being required to exercise independent judgement and to examine any decision holistically. We think that the new S.172 reporting requirements should help focus Directors' attention towards complying with all their duties but that these will – as previously stated – need to be combined with a much more robust enforcement and sanctions approach and framework.

Q15. Should government consider new options to protect payments to SMEs in a supply chain in the event of the insolvency of a large customer? Please detail suggestions you would like to see considered.

N/A

Q16. Should Government consider removing or increasing the current £600,000 ca on the proportion of funds that can be ring-fenced and paid over to unsecured creditors (the "prescribed part") or enabling the higher cap in larger insolvencies? What would be the impact of increasing the prescribed part?

N/A

Q17. Is the current corporate governance framework in the UK, particularly in relation to companies approaching insolvency, providing the right combination of high standards and low burdens? Apart from the issue raised specifically in this consultation document, can you suggest any other areas where improvements might be considered?

On the broad issue of the UK's corporate governance framework, we note that there are currently several initiatives in this area, including the Kingman inquiry into the role, governance and effectiveness of the FRC which we think is adding a level of additional uncertainty for the industry. It is important that any future changes are aligned – to avoid duplication and confusion – and also that a thoughtful, considered and long-term approach is taken. We look forward to feeding in more fully on stewardship issues through the forthcoming consultation on the Stewardship Code.

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