PENSIONS AND LIFETIME SAVINGS ASSOCIATION

10th August 2018

Direct: +44 (0)20 7601 1722
Email: caroline.escott@plsa.co.uk

Sir John Kingman
Review Secretariat
Department for Business, Energy and Industrial Strategy
1 Victoria Street
London
SW1E 5ND

Dear Sir John,

PLSA RESPONSE: Independent Review of the Financial Reporting Council (FRC)

The 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 service 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.

Our members therefore have a clear interest in an effectively functioning Financial Reporting Council (FRC), not only through its role in monitoring and maintaining the UK Corporate Governance and Stewardship Codes, but also regarding its position as regulator of the audit and accountancy professions; investors need to have confidence in the quality of financial reports and accounts to make the right investment decisions.

As stewardship becomes increasingly mainstream and given policymaker and industry concerns about competition in the audit market, we welcome the timely decision to undertake a wide-ranging review of the FRC, and the opportunity to feed in. Many thanks to the Kingman team for taking the time to engage with us and our members in previous weeks – our response builds on the views we and our members have expressed in these previous discussions. We have grouped our views along themes which are consistent with those of the Review's questions which are most pertinent to our membership.

The FRC's Purpose and Function

The FRC has made a clear and significant contribution to building a more transparent corporate system and helped to ensure that the UK corporate governance regime is internationally well-regarded. Its work on initiatives such as the Stewardship and Corporate Governance codes has served as the inspiration for similar initiatives elsewhere. We also appreciate the recent expansion of its efforts to engage with the investor – including asset owner – community through initiatives such as the Investor Advisory Group.

As the Review acknowledges, the FRC has undergone a significant period of change in terms of its scope since its creation in the 1980s. Although we recognise that the 2012 review of the FRC's governance was intended to correct what we think has become a regulator with an amorphous mission and set of responsibilities, we do not believe the changes it brought about have been entirely successful in ensuring the FRC can effectively carry out its role now. Its mission statement should be more narrowly defined, explicitly drawing out specific aspects of its role such as the intended objectives (to promote/support long-term and sustained investment in the UK).

As the FRC's remit has broadened and the political situation has changed, the scope of its powers have not necessarily kept pace and its objectives remain unclear and ill-defined. This lack of clarity is reflected in the FRC approach, for instance the lack of alignment between its audit and accountancy powers and those on stewardship and corporate governance issues, resulting in anomalies such as its inability to sanction Directors for poor behaviour unless they happen to be a chartered accountant. In this specific area, we believe serious consideration should be given to allowing the FRC greater sanctioning and enforcement powers for all Directors which fail to comply with their duties, given the joint and several nature of Director responsibility (please also see our later comments).

We believe there is merit in having a regulator which looks at the full breadth of the framework governing corporate transparency and integrity. The UK's regulatory framework governing corporate behaviour is currently split across several organisations including Companies House, the FRC, the Insolvency Service, the UK Listing Authority and the FCA. Although there are various Memoranda of Understanding and similar between these organisations, there could be merit in taking a holistic view of the ways in which responsibilities are split and bringing some of these together, potentially within the FRC. This could help avoid some of the current duplication, as highlighted in the recent investigation into Carillion's collapse, where the FRC, the Insolvency Service, the FCA and the BEIS Select Committee all undertook separate and overlapping investigations.

A key consideration in any change to the remit of the FRC must be the level of the resources required in order to ensure it carries out its new role effectively. PLSA members have expressed

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concerns that the FRC does not even have the resources necessary to be as effective as possible within its *current* remit. Please also see our later comments on the levy framework.

FRC leadership and resources

We think that the imbalance between the FRC's audit/accountancy and corporate governance and stewardship powers is reflected in the balance of backgrounds of its staff, with what seems to be a significant and dominant proportion drawn from the accountancy and audit professions, as opposed to those with investor practitioner expertise and experience. Although the two are not mutually exclusive, we would welcome greater representation of the investor viewpoint at every level of the FRC and think this could be a helpful step towards supporting an effective framework for corporate governance and stewardship.

It is important to note that the thrust of our concerns is not that the FRC – in common with other regulators and policymaking bodies– draws upon the pool of former practitioners in the regulated field, but more that despite the significant and growing importance of its work to investors (the consumers of corporate financial statements and accounts as well as the intended audience of the Stewardship and Corporate Governance Codes) there remains a relative imbalance.

The FRC's effectiveness

Our members have consistently expressed concerns about the lack of transparency of the FRC's investigative processes and procedures such as its Corporate Reporting Reviews (CRRs) and Audit Quality Reviews (AQRs). In addition to the well-publicised concerns surrounding the FRC's approach to HBOS and BHS, we have heard reports (including some specific cases which we are happy to discuss further) that if an investor expresses concern about for instance an auditor's lack of compliance with professional standards, that either it is unclear what action has been taken forward or – should an investigation have been undertaken – on what basis the FRC reached its conclusions. We believe that greater transparency – both to stakeholders and the public – about the FRC's important investigative work would be helpful both to increase trust in the FRC's approach and to provide clear and up-to-date guidance to its stakeholders regarding what is considered good and poor practice. The Pensions Regulator (TPR)'s approach in this area is instructive.

Greater transparency regarding the outcome of and processes governing inquiries into the audit sector in particular could help combat the perception that the FRC has succumbed to 'regulatory capture' given the high numbers of former accountancy and audit professionals in its staff.

Asset owners and the Stewardship Code

Asset owners have a unique role in drawing stewardship along the investment chain, providing the commercial incentive for their investment managers to engage with investee companies on their behalf. Informed engagement – including exercising their voting rights – is a clear responsibility of pension funds and an implicit fiduciary duty of trustees and the investment manager to whom asset owners delegate this function. Good stewardship of assets can protect companies against reputational risk and play a key role in controlling investment risk.

Asset owners understand the importance of effective stewardship, with 71% of respondents to the PLSA's 2017 Stewardship Survey saying that they take stewardship considerations into account in manager selection. However, while the FRC's work on stewardship and corporate governance is therefore of relevance to pension funds, few asset owners engage directly with the FRC– including signing up to the Stewardship Code. This is for several reasons:

1) Most UK pension funds now hold only a relatively small proportion of UK equities, which makes the direct relevance of the Code less clear (we recognise that it is possible and desirable to undertake stewardship on a broader range of asset classes than just equities, but the Code only applies to equity holdings).

2) Many UK pension funds outsource their stewardship to their asset managers; this is particularly the case for smaller pension schemes, or those who do not feel they have the necessary expertise and resource to engage directly with companies. Although there are provisions (1 and 7) in the Code which specify how they might apply differently to a pension fund and a commercial asset manager, the current Code is clearly less relevant to asset owners which outsource most of their stewardship activity as opposed to those which invest directly.

3) UK pension funds want to maintain a flexible and meaningful approach to stewardship, choosing the right approach which achieves value for scheme members instead of simply undertaking stewardship for compliance purposes. Our non-signatory members support and apply most of the Code's provisions but many are reluctant to sign owing both to concerns that doing so may inhibit flexibility and the resource implications of monitoring all their stewardship activities.

The PLSA is proactive in supporting all pension schemes to be good stewards of their assets and we strongly support the work of the Stewardship Code, including through trying to raise awareness of the Code amongst pension funds via our Stewardship Disclosure Framework. The FRC has been keen to encourage asset owners to sign up to the Code but we would urge it to be

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mindful of the fact that, as currently constituted, there is a natural 'ceiling' to the numbers of asset owners that will do so for the reasons outlined above.

It seems to us that a better focus might be to introduce specific guidance under each provision for different parties – setting out how asset owners can hold their asset managers to account in terms of how well they undertake the specific activities and raising awareness amongst non-signatory members around this guidance.

We also think that the FRC should devote more resources to working with the industry to combat some of the misperceptions around broader stewardship issues; for instance, that it is not possible for smaller funds or those invested primarily in pooled or passive funds to have a meaningful approach to stewardship. We believe that the current balance of priorities on the best way to support good stewardship by asset owners might reflect the relative lack of investor (and particularly asset owner) representation within the FRC highlighted above.

The effectiveness of the Stewardship Code

We support the current high-level and principles-based approach taken by the Code. Anything more prescriptive runs the risk of turning stewardship into a box-ticking exercise (please see our comments above).

The PLSA supported the recent move towards tiering of signatories based upon their performance against the Stewardship Code. However, in practice it remains unclear how effective this has been in distinguishing between those who are the most effective in undertaking stewardship and those who are taking a more 'box-ticking' approach.

In part, we believe this is because the FRC does not have sufficient resources to be able to monitor the Code as effectively as possible. A proactive approach to oversight and engagement would be helpful in preventing a proliferation of boilerplate disclosures or approaches to stewardship. This would help pension schemes to better understand how effective their manager is.

The FRC, corporate governance and corporate failure

We have fed in separately to various recent government consultations[1] on the issue of corporate governance and failure. It is vital that policymakers take a holistic and long-term view when considering how to improve corporate governance and the role of the FRC in upholding

[1] Including the Department for Business, Energy and Industrial Strategy (BEIS)'s recent *Insolvency and Corporate Governance* paper, its consultation on *Corporate Governance Reform* and the relevant papers forming part of DWP's DB White Paper programme of work.

standards. The UK corporate governance regime is globally well-regarded and UK institutional investors have a strong 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 that, despite recent high profile corporate failures, such events occur infrequently.

However, we believe that more should be done to strengthen the FRC's effectiveness on corporate governance issues. In particular, there needs to be a greater focus on *enforcing* Directors' duties in respect of s.172, including an appropriate sanction regime (e.g. Director disqualification). Although we believe that the new reporting requirements in this area will be helpful in ensuring shareholders have better visibility of any poor corporate behaviour, we believe that for the regime to have teeth, this needs to sit alongside a robust enforcement and sanctions structure. We believe that there would be merit in giving the FRC greater powers in this respect and that the FRC should work with industry to ensure that any changes in approach and how these powers are used are clearly understood by, and communicated to, stakeholders.

FRC funding

Pension schemes with more than 5000 members are subject to an FRC levy to support the funding of its actuarial responsibilities which "underpin the quality of the actuarial work [and are] highly relevant to administrators, trustees and managers of pension funds… who rely on actuarial advice".

The levy is a voluntary one, though the FRC notes that "should this voluntary approach prove unsustainable, the FRC would formally request that the Secretary of State make regulations for the FRC to levy its funding on a statutory basis" but we do not believe that the voluntary nature of the levy is given sufficient clarity and prominence on the FRC's website. The FRC's approach to levy collection, where follow-up reminders are received as if the levy were obligatory, creates further confusion.

There should also be greater clarity regarding the payment approach for hybrid schemes, where there will be one set of accounts for a DB section and a DC section. It is currently unclear whether the FRC expects each section of the scheme to meet the invoice in proportion to the membership numbers. Steps should be taken by the FRC to ensure pension funds are clear as to the nature and composition of the levy, as well as to communicate what the pensions levy funds and what it does not.

Should the levy arrangement be changed – in line with any changes to the future role and scope of the FRC – it is clear that a full consultation would be needed to ensure that the structure of the levy is fully aligned with the organisation's functions. Work would also need to be undertaken with the industry to make sure that costs are fairly distributed in a way which reflects the benefit of the FRC's work to each category of levy-payers.

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We hope that this response is helpful. If you would like to discuss anything further, please do not hesitate to get in touch.

Yours sincerely,

Caroline Escott
Policy Lead: Investment and Defined Benefit

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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.

Registered office: Cheapside House, 138 Cheapside, London, EC2V 6AE