NAPF

Securing the future of pensions

Institutional Investment in the UK Six Years On

January 2007

A Discussion Paper from the NAPF

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Securing the future of pensions

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Foreword by the Economic Secretary to the Treasury

Ed Balls, MP

In March 2000, the Chancellor of the Exchequer asked Paul Myners to examine whether there were distortions in the investment decision-making of institutional investors. One of Myners' main conclusions was that many pension fund trustees lacked the necessary investment expertise to act as strong and discerning customers of their investment consultants and fund managers who sell them services, with consequential effects on their investment decision-making. Myners recommended, and the Government endorsed, that pension fund trustees voluntarily adopt a series of 'comply or explain ' principles codifying best practice in investment decision-making.

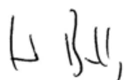
These Myners principles, the Government believes, represented and still represent a clear and coherent approach for investment decision-making. They benefit consumers, industry and the Government, and particularly pension funds.

The Government welcomes the progress made by pension funds in adopting the principles since they were endorsed. However, the previous review in 2004 noted that there remained some areas in which progress had not gone as far as had been expected.

During the 2004 review, the NAPF agreed to undertake a further review in 2007. The Government is pleased that the NAPF is undertaking this review. This will help determine if the gaps identified in 2004 have been closed. By assessing the changes in behaviour and practice resulting from the principles and making recommendations, the NAPF's review will help the Government decide whether amendments to the principles are needed to improve pension scheme governance, and in particular the efficiency of investment decision-making.

This review is an important step towards greater ownership of the principles by the pensions community. Increasing the industry's advocacy and promotion of the principles is essential to their continued utility and development. Indeed, I see it as a natural next step following the Government's decision to adopt the voluntary 'comply or explain' approach of the Myners principles. The benefits of flexible application and low compliance costs deriving from the principles rely on the continued engagement of stakeholders with the principles and the commitment and transparency they demonstrate in 'complying or explaining'.

I encourage all interested parties to work with the NAPF to make this review a success.



Ed Balls MP
Economic Secretary to the Treasury

Executive Summary

- In March 2000 HM Treasury commissioned Paul Myners to undertake a review of institutional investment in the UK. His report, together with a set of voluntary Principles for occupational pension schemes, was published in 2001. A 2004 HM Treasury review of compliance found that, whilst progress was lacking in certain areas, in others, trustees were complying with the Myners Principles.

- **The NAPF has agreed to undertake a further review of compliance**. This Discussion Paper, which seeks the views of a range of stakeholders on the Principles, is the start of the review process. This Review will be completed by October 2007.

- **The environment in which pension funds are operating has changed significantly** since the Principles were first published in 2001. Then, many schemes were in surplus and the focus was on how to expand institutional investment into new areas such as venture capital. Six years on that scenario has been turned on its head. Now the focus is on deficit correction, the strength of scheme sponsor covenants and scheme-specific funding. Increased longevity and adverse market movements have contributed to deficits and the sensitivity of sponsor companies to this has been raised by new accounting provisions. In response sponsors have closed schemes or increased contributions and there has been a shift in investments from equities to bonds. The financial innovations employed in order to deal with deficits have raised the bar for trustees in terms of the knowledge and understanding expected.

- Despite the increased pressures, financial and regulatory, on trustees **the evidence suggests there has been considerable progress in compliance** for example in the areas of shareholder engagement and asset allocation. Where voluntarism has been expected, it has been forthcoming. The views of respondents are sought in assessing what further progress has been made since HM Treasury last reported on progress in 2004.

- **But in other areas, progress has been uneven.** For example it has been slow on Principle 8 (performance measurement) because there remains no agreement on assessing advisers. Small schemes appear to be less compliant than large ones and DC schemes less so than DB schemes. Again, the views of stakeholders are sought.

- **In this new world of pensions, some of the Myners Principles appear less relevant.** They say nothing about the need to manage mismatches in assets and liabilities (eg in duration), the shift from equities to bonds has reduced the potential impact of shareholder engagement and the spread of financial innovations has obliged trustees to delegate more to advisers, which runs counter to the Principles (intended to ensure that trustees can engage with and if necessary challenge advisers and consultants). Furthermore, the shift from trust-based DB schemes to contract-based DC schemes means that an increasing number of pensions savers and a growing pool of assets will be covered in schemes which are outside the Myners universe.

- **Throughout 2007 the NAPF will be discussing with stakeholders the issues raised in response to this consultation document and other related issues**.

We look forward to hearing your views.

Preface

In March 2000, HM Treasury commissioned Paul Myners to conduct a review of institutional investment in the UK. His report was published in March 2001[1]. He recommended that in the interests of good governance, pension fund trustees should voluntarily adopt a series of ten Principles. The Government accepted this recommendation, as well as Mr Myners' proposal that after two years it should review the effectiveness of the Principles.

In December 2004 the Government released its Review[2]. This found that, while voluntary action was being taken against the Principles, progress was lagging in several key areas. Therefore the Government proposed to revise the Principles to strengthen and amplify what they said in respect of these problem areas. A consultation was held on these proposals. The National Association of Pension Funds agreed to undertake a further progress review in 2007. In the light of the evidence and recommendations from the NAPF's progress review, the Government will consider the need for policy action, including whether to take forward any of the proposals suggested in 2004. The Terms of Reference of the NAPF's review are set out in Appendix 1.

This Discussion Paper begins the process of the 2007 Review. We are seeking the views of stakeholders – occupational pensions schemes, the investment industry, trustees, pension fund members and their representatives, and employer representatives – on pension funds' progress against the Principles. Throughout the paper we pose some of the questions that will need to be answered in the Review. For ease of reference they are brought together and repeated at the end of the paper. Please write to us giving your views on the issues and questions raised. The responses to this consultation exercise, together with the results from primary research amongst trustees and pension schemes and dialogue with key stakeholders, will inform the final report that will be presented to HM Treasury in 2007.

Please write by **Friday 13 April 2007** to:

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[1] Institutional Investment in the UK: A Review, HM Treasury, 2001.
[2] Myners Principles for institutional decision-making: review of progress, HM Treasury, 2004.

1: Background

1. In 2000 the Chancellor of the Exchequer expressed concern that institutional investors might be unduly restrictive in the universe of assets they considered for investment. If this was indeed the case, then newer and smaller companies might have difficulty attracting capital and pension funds might not maximise returns to their members. HM Treasury therefore commissioned a report from Paul Myners, then Chairman of Gartmore Investment Management, to consider whether there were factors restricting the asset allocation of institutions.

2. With the possible exception of private equity, the report (*Institutional Investment in the UK: A Review*[3]) did not examine the asset allocation of pension funds as such but it did consider the ways in which trustees determined investment strategy and the sources of advice they receive. It also suggested a number of ways in which institutional investors fell short of "best practice", the implication being that rates of return were not being maximised.

3. It recommended ten Principles for defined benefit (DB) schemes and eleven for defined contribution (DC) schemes covering the following areas:

The Myners Principles

Principle 1:	Effective decision-making
Principle 2:	Clear Objectives
Principle 3:	Focus on asset allocation
Principle 4:	Expert Advice
Principle 5:	Explicit Mandates
Principle 6:	Activism
Principle 7:	Appropriate Benchmarks
Principle 8:	Performance Measurement
Principle 9:	Transparency
Principle 10:	Regular reporting

For defined contribution schemes there was an additional Principle on "Choice of Default Fund".

Both sets of Principles are set out in full in Appendix 2.

4. Further, it recommended that pension funds should set out in their Statement of Investment Principles (SIP) the steps trustees were taking to implement each of the Principles. If trustees chose not to meet any of the Principles, the Report said that they should explain publicly, and to their members, why not.

[3] Institutional Investment in the UK: A Review, HM Treasury, 2001
http://www.hm-treasury.gov.uk/media/2F9/02/31.pdf

“I am pleased that the NAPF has agreed to undertake a thorough review of the Myners Principles over the course of next year, which will be a great platform for debate on how the Government works with the industry to keep up the momentum.”

Ed Balls MP 14 December 2006

5. HM Treasury published a review of progress in December 2004[4]. It concluded that progress had been made in a number of areas, stating that: “Over half of all trustees surveyed agreed that the Principles provided guidelines for best practice, and had encouraged formalisation of previously *ad hoc* behaviour, leading to trustees being better informed, and addressing issues they would not have otherwise considered….. Around 70% of schemes reported that they were fully, or mostly, compliant with the Principles in aggregate.” Furthermore, it found that schemes accounting for 74%-80% of total DB and DC scheme membership surveyed had considered and acted upon Principles 2 (clear objectives), 3 (asset allocation), 5 (explicit mandates) and 7 (appropriate benchmarks).

6. But the 2004 Review also noted that in certain areas, progress was lacking, for example:

   - Many trustee boards had not yet attained the levels of skills and expertise necessary to achieve the improvements in investment decision-making envisaged by the 2001 report **(Principle 1)**.
   - Although 80% of schemes were strengthening their asset allocation decisions, this tended to be in response to changing market conditions rather than a direct response to the Principles **(Principle 3)**.
   - Action in relation to explicit mandates **(Principle 5)** did not extend “to adopting the recommendations on timescales for evaluating managers, despite the importance attached to it by the Myners Review”.
   - Although 51% of DB and DC schemes (weighted by membership) had acted on shareholder activism **(Principle 6)**, progress was greatest amongst large schemes[5]. It translated into just 15% of all schemes - only 10% of small schemes had acted on Principle 6.
   - Progress on **Principle 8** (performance measurement) was poor.
   - There was poor quality of commentary on, and disclosure of, progress in implementing the Principles. Only 53% of schemes documented their approach to the Principles in their SIP or through other means.

7. As a result of the 2004 Review, HM Treasury recommended some further amendments to the Principles and consulted

[4] Myners Principles for institutional decision-making: review of progress, HM Treasury, 2004.
[5] Large schemes were defined as those with over 1000 members.

further on these and their findings. In a speech on 14 December 2006, the Economic Secretary said that the 2004 proposals will be considered in conjunction with all the other issues arising from the 2007 Review. This is to be conducted by the NAPF. The results will be presented to HM Treasury in the Autumn and in the light of the NAPF's evidence, the Government will consider what further action is needed.

2: Six years on – a transformed world for pensions

8. The environment in which pension funds are operating has changed significantly since 2001. Then, many schemes had surpluses[6] and the focus was on how to expand institutional investment to new areas, eg venture capital. Within just six years, that scenario has been turned on its head. Now the focus for trustees and their advisers is on deficit correction, the strength of sponsor covenants, scheme-specific funding, Liability Driven Investment and the shift from DB to DC. Encouraged by the Pensions Regulator, trustees have begun to think of the future pensioners of a company scheme as unsecured creditors. This has helped to further concentrate the minds of trustees, for example encouraging them to negotiate improved covenants for pension funds. The risk–based nature of the Pension Protection Fund (PPF) levy has acted in the same direction since the stronger the scheme, the sponsor and the covenant, the lower the levy[7].

"The environment in which pension funds are operating has changed significantly since 2001."

9. The remainder of this section examines in detail the most significant changes that have impacted on the operating environment for pensions and institutional investment since 2001:

   (i) Shift from DB to DC
   (ii) Dealing with deficits
   (iii) Investment trends
   (iv) Strategic advice
   (v) Increasing regulatory burden
   (vi) Implications for the Myners agenda of the transformed world for pensions

(i) The shift from DB to DC

10. In recent years many plan sponsors have closed their DB schemes to new members with some 13% of private sector funds going further and stopping future accruals for existing members[8]. The proportion of all private sector schemes (whether open or closed) that are DB has fallen from 78% in

[6] See for example Accounting for Pensions Survey, Lane, Clark and Peacock, 2002. Of the 57 FTSE100 companies reporting in 2001 using FRS17, broadly half showed a surplus and half a deficit.

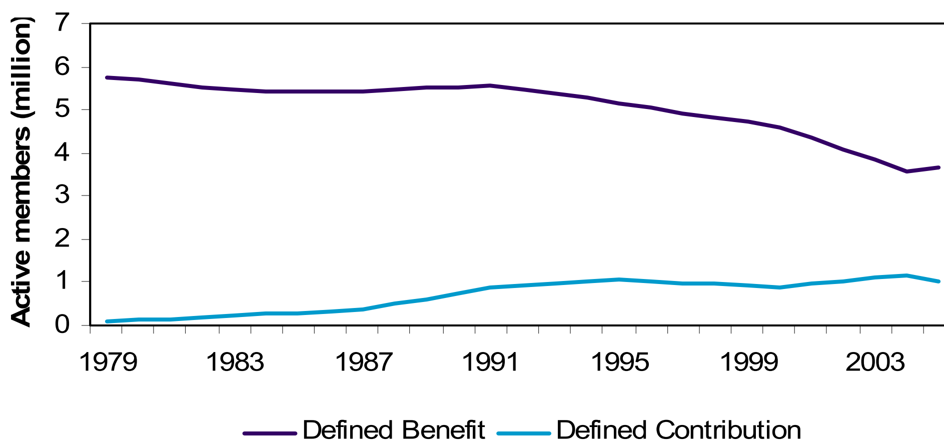
[7] Around 20% of the PPF's levy income comprises a levy related to the liabilities of schemes. The remaining 80% comprises a levy which is related to the risk posed by a scheme to the PPF. The risk based element must take account of both the funding level of a scheme and the risk of insolvency of the sponsor.

[8] The Purple Book, The Pensions Regulator & the Pension Protection Fund, 2006 - Chart 3.1, p18.

1999 to 49% in 2005 and today less than half of all DB schemes are open to new members. 4% are closed both to new members and future accruals[9]. Although some sponsors remain committed to DB schemes and the weight of invested money will for many years relate primarily to DB schemes, the need for best practice in DC investment will be of increasing importance for the future. However, much of the new DC provision is through contract-based schemes and hence is outside the scope of this Discussion Paper[10].

11. Figure 1 below shows that between 2001 and 2005, the number of active members in DB schemes has fallen from 4.3 million to 3.7 million. By contrast, the number in trust-based DC schemes has risen slightly (from around 950,000 to 1.1 million). And over a similar period (2000-2005) the numbers saving in workplace-based non-trust DC schemes (including stakeholder and Group Personal Pensions) also rose slightly, from 2.2 to 2.5 million[11].

Figure 1: Membership of private sector occupational pension schemes (millions)



Source: Government Actuary's Department

(ii) Dealing with deficits

(a) The spread of deficits

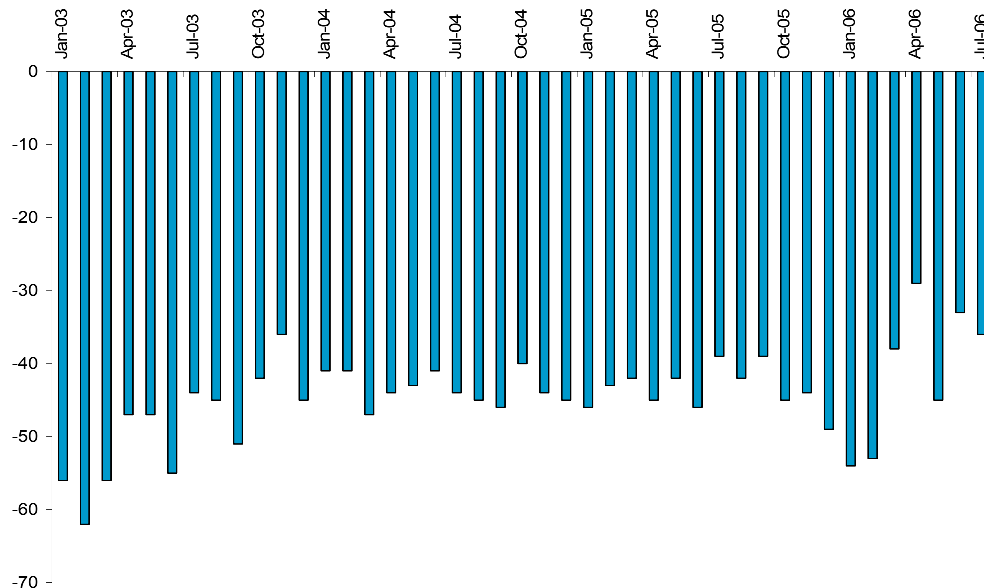
12. There are a number of reasons why sponsors have closed DB schemes: increasing costs due to improving longevity, the

[9] Annual Survey, NAPF, 2005.
[10] Although the remit of the Myners Report ranged across all institutional investment, in practice its authors focused on trust-based occupational pension schemes, life insurance companies and pooled investment vehicles.
[11] These numbers are bigger than the ones in Figure 1 which cover only those DC schemes that are trust-based. The sources for these data are Employers' Pension Provision Surveys, published by DWP.

disclosure of the scheme funding position in FRS17 reports and the growing burden of regulation and the additional costs associated with that. But a major reason behind scheme closures has been the spread of scheme deficits. *Institutional Investment in the UK: A Review* was written in a world where many schemes had surpluses. This was reflected in the fact that it included a chapter entitled "Pension Fund Surpluses". Between 1995/96-2000/01, employers took contributions holidays worth £2.7 billion[12]. The situation today is very different. Deficits have developed due to the combination of lengthening life expectancy and fixed pension ages, exacerbated by falling bond yields and a long period of falling equity prices. Since 2003, the FRS17/IAS19 aggregate deficit of pension funds of companies in the FTSE100 index has varied between around £30 billion and £60 billion[13], as shown in Figure 2. The introduction of FRS17/IAS19 was an important factor concentrating the minds of company boards on the liabilities they were carrying in the pension scheme and has been a major cause of change in their approach to the schemes they sponsor. The impact of the new accounting standard was enhanced by their timing, shortly after the Turnbull Report[14], which encouraged boards to be more critical of the risks they were running.

[12] Source HMRC.
[13] FRS17 was phased in from 2002. It became mandatory in accounts for periods ending on or after 22 June 2003. The deficit figures are calculations by the actuaries Lane, Clark and Peacock.
[14] Internal Control: Guidance for Directors on the Combined Code, Financial Reporting Council, 1999. An updated version was issued in 2005.

Figure 2: Estimated FRS17/IAS19 deficit for FTSE 100 companies (£bn)



Source: Lane, Clark and Peacock, Accounting for Pensions: Annual Survey 2006

13. In order to assess the strength of the employer's covenant[15], a deficit needs to be assessed not just in absolute terms but in relation to the financial strength of a company, as measured for example by market capitalisation or profitability. A number of major UK companies have significant deficits as measured against their market capitalisation, as shown in Table 1.

Table 1: Largest deficits in relation to market capitalisation (2005)

	Deficit £m	Market Cap £m	Deficit/Market Cap %
British Airways	1531	2857	54
BAE Systems	5306	12256	43
ICI	1491	3955	38
BT Group	4781	17579	27
Rolls-Royce Group	1394	7516	19
Rexam	514	2805	18

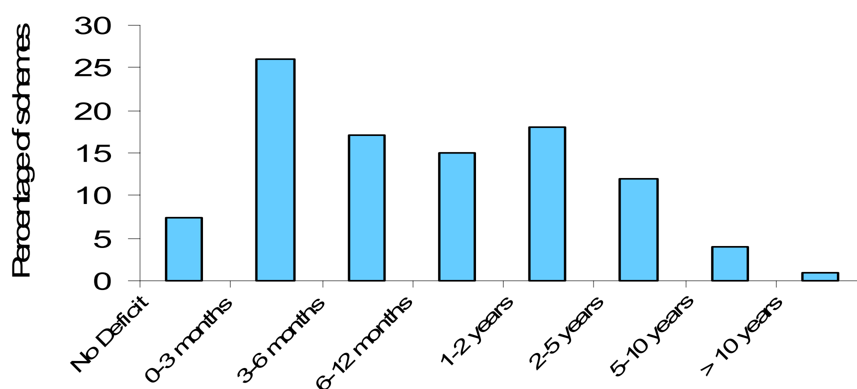
Source: Lane, Clark and Peacock, Accounting for Pensions: Annual Survey 2006

[15] The covenant is defined as the employer's financial position and prospects as well as its willingness to continue to fund the scheme. See Regulatory Code of Practice 03: Funding defined benefits, The Pensions Regulator, February 2006.

14. The importance of assessing the deficit in relation to the financial strength of the company is well illustrated by comparing two FTSE100 companies, British Airways and BP. They have similar deficits in their pension funds (£1.5 billion for BA and £1.4 billion for BP) but measured against market capitalisation, the BA deficit is much bigger at over 50%, versus just 1% in the case of BP.

15. Figure 3 shows a wide range of time-spans needed - in terms of multiples of annual profits - for companies to eliminate their pension deficits. 66% could clear their deficits with less than 1 year of profits but there is a long 'tail' of companies where more than 2 years of profits is needed.

Figure 3: Company Contributions – Affordability[16]



Source: Aon Survey of around 200 large companies including the FTSE100

(b) Longevity

Life expectancy for a 65 year old has risen by 7.5 years since 1950

16. Increased longevity combined with fixed pensionable ages has been one of the main causes of significant scheme deficits. According to the Government Actuary's Department (GAD), in 1950 a man reaching the age of 65 had a cohort life expectancy[17] of 12 years. By 2001, this had risen by more than 50% to 18.6 years. By 2006 it had risen still further, to 19.5 years, and by 2050 it will have risen to 23.6 years, almost doubling as compared with 1950. An extra year of life expectancy adds some 1% to the life of a 65 year old male, but it adds more than 5% to his pension cost, since the period for which he can expect to earn a pension is 19.5 years. During 2005 alone, rises in life

[16] Number of years of profits required to clear accounting deficits.
[17] Cohort life expectancies are worked out using age-specific mortality rates which allow for known or projected changes in mortality in later years.

expectancy forecasts were estimated to have added £20 billion to companies' pension liabilities[18].

17. Moreover, the rise in longevity has been consistently greater than has been forecast by scheme actuaries. In 1981 GAD projected that by 2004 male life expectancy at 65 would be 14.8 years; now it projects a lifespan of 19.2 years for a man who turned 65 in 2004.

(c) Adverse financial market trends

18. The adverse impact of rising life expectancy on pension fund solvency was exacerbated by financial market trends. From 1999 through to 2002, there was a sharp and almost continuous fall in equity prices. The peak-to-trough fall in the FTSE100 index was around 50%. The value of equities within pension fund assets therefore fell sharply. Simultaneously, bond yields were falling, due to falling inflation and official interest rates. Under FRS17, the Net Present Value of liabilities is calculated using a bond-related discount rate. So the value of pension fund liabilities was rising for this reason as well as due to rising longevity – at just the time when the value of equities was falling. With asset values falling and liabilities rising, pension funds moved into widespread deficit.

(iii) Investment trends

19. Several otherwise disparate elements of this 'brave new world' for pensions are pointing in the same direction as regards scheme investment – away from equities and towards bonds.

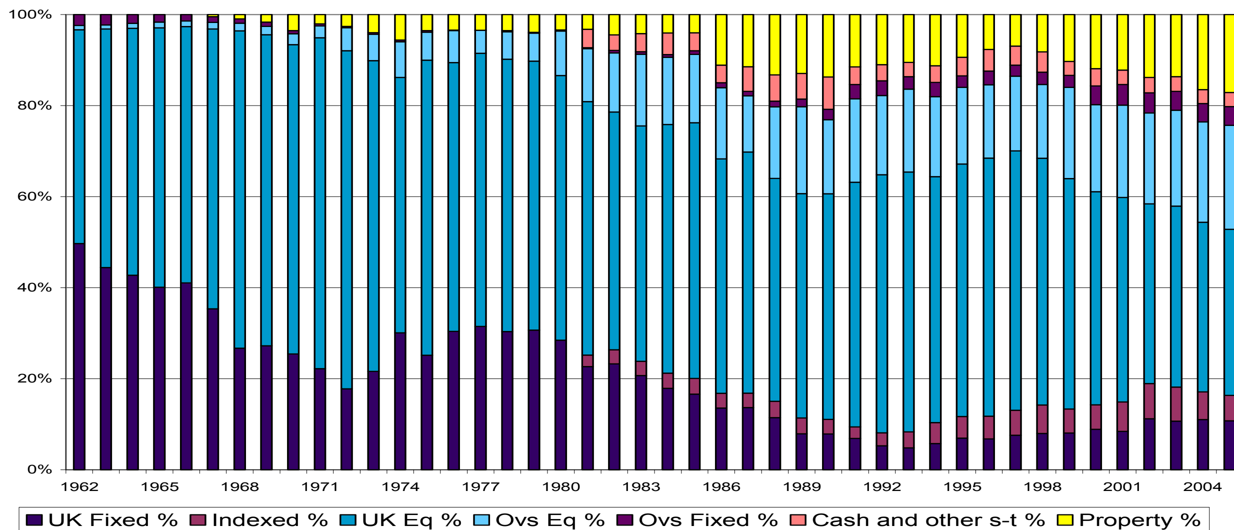
    - Particularly for schemes in deficit, and especially where the employer's covenant is weak, the imperative of managing a mismatch between assets and liabilities has led trustees to consider a shift into bonds. A number of schemes have adopted Liability Driven Investment (LDI) strategies, involving not just a switch to bonds but also the use of swaps and derivatives to more accurately match assets to liabilities. For scheme sponsors, FRS17 made the pensions funding position explicit for the first time and introduced a bond-related discount rate for calculating pension fund liabilities. Both these factors gave additional impetus to the switch to bonds.

    - For those DB schemes which have closed, the average age of their members has begun to rise, making a bond-based strategy more attractive.[19]

"For scheme sponsors, FRS17 made the pensions funding position explicit for the first time and introduced a bond-related discount rate for calculating pension fund liabilities."

[18] Higher life expectancy costs UK quoted companies £20bn over 2005, KPMG News, May 2006.
[19] In the extreme a pension fund with no active members should – provided it has a surplus - be entirely invested in bonds, chosen with maturity dates to match its payment obligations.

Figure 4: Pension Fund Asset Allocation



Source: ONS MQ5

(data for cash and other short term assets are not published for years prior to 1981; data for property holdings are not published for years prior to 1967)

20. The result has been to reduce the share of equities in pension fund portfolios from over 70% in 1999 to under 60% in 2005. The share of bonds by contrast rose from 16% to over 20%[20]. Figure 4 shows pension fund asset allocation over the last four decades.

21. However there are limits to the shift to bonds:

- Trustees and sponsors are aware that switching to an LDI strategy when in deficit simply locks in the deficit. Some schemes are using LDI strategies to leverage their investments and finance return-seeking portfolios which are designed to erode the deficit. These strategies usually seek diversified sources of return from markets and skill (beta and alpha) and use derivatives widely in a way not generally employed before the 2001 Report. Other schemes adopt partial LDI solutions against some of their liabilities and use traditional active long-only equity investment to erode the deficit.

- There is a shortage of long dated bonds and indexed bonds. Hundreds of billions of pounds' worth of pension liabilities (some £350 billion on an IAS19 basis for the FSTSE100 companies) cannot be matched by £84 billion of

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[20] Source ONS.

long conventional and £20 billion of long index-linked bonds (the total issuance of gilts with a redemption date 20 or more years away) – moreover, most of these bonds have already been locked away by pension funds and insurance companies)[21]. Greater use of LDI strategies would exacerbate the shortage of long bonds. The developing swaps market eases but does not eliminate the bond shortage. Moreover, the greater use of swaps raises the bar in terms of the knowledge and understanding expected of trustees (see paragraph 22).

(iv) Strategic Advice

22. Partly in response to the move of schemes into deficit and the change in asset allocation, there has been a proliferation of sources of input into investment strategy. The Myners Report itself was a factor in this, as was a competition organised by the Universities Superannuation Scheme[22]. Most investment banks and many investment managers now offer strategic advice to scheme sponsors. Many also offer implementation services using swaps or pooled vehicles offering a like service with simplified administration. Derivative-based products and other financial innovations (eg swaps) have also become more widely used. While undoubtedly helpful additions to the trustees' toolkit, the need to understand these complex innovations has significantly raised the bar in terms of the knowledge and understanding expected of trustees.

(v) Increasing regulatory burden

Legal and regulatory change

23. At the same time as trustees and their advisers were grappling with the move into deficit, they were also confronted by a massive volume of regulatory change. The Pensions Act 2004 introduced the Pensions Regulator, the PPF and the associated new provisions such as scheme specific funding which require trustees to agree with the scheme sponsor a Statement of Funding Principles. The Act contained 100 new sets of regulations and provided for up to 12 new codes of practice. The Finance Act 2004 introduced a new method of calculating maximum tax-privileged pension benefits, in the form of the lifetime allowance. It included 40 sets of new regulations and the accompanying Technical Notes[23] alone run to 3000 pages.

The Finance Act 2004 included 40 sets of new regulations and 3000 pages of technical notes.

24. The Pensions Regulator's Code of Practice on TKU made the trustee role more demanding. As well as more onerous duties

[21] See also Financial Market Trends, OECD, April 2006. This estimates the stock of long dated gilts at around one quarter of pension fund liabilities.
[22] *Investing Pension Funds as if the Long Term Really Did Matter,* organised by USS and Hewitt Bacon and Woodrow, January 2004. See www.usshq.co.uk
[23] The Registered Pension Schemes Manual, HMRC.

and greater potential for conflicts of interest, trustees risk being fined up to £5,000 if they fail to notify the Regulator of events which may eventually lead to the PPF having to meet some of the scheme's liabilities. Thus far, there is no sign that potential trustees are being deterred by these greater demands – the NAPF's 2005 Survey found that only slightly over 2% of trustee positions are vacant. But it is a risk, especially as most trustees are unpaid[24] apart from expenses, or where employees are unpaid for the added responsibility. (The Myners Report suggested it was good practice to pay trustees unless it was thought unnecessary, eg for a senior executive of a sponsoring company.) Most recently, trustees and their advisers have had to incorporate new provisions on age discrimination into their scheme rules.

25. Another result of the combination of the move into deficit and the introduction of the scheme specific funding provisions is the need for trustees to become more expert in assessing the financial position of the scheme sponsor, as well as that of the scheme. Trustees now have to be involved in often complex financial negotiations with the sponsor, especially at the time of a corporate transaction. Assessing and maybe attempting to strengthen the employer's covenant can involve negotiating the grant of contingent assets to the scheme. This can include for example letters of credit; a prior charge over assets; an escrow account; a parent guarantee; or a 'special purpose vehicle'. The trustees' assessment of the strength of the employer's covenant can also affect their investment strategy.

Intensification of conflicts of interest

26. Most trustees are currently employed or have in the past been employed by the sponsoring company[25] (they are often also directors). Trustees who are also employees have always risked conflicts of interest. But the introduction of the scheme specific funding regime, together with the move to widespread pension fund deficits, has considerably intensified the problem. Under the new regime, trustees have to ensure the solvency of their schemes and the provision of adequate funds from the sponsoring employer. Trustees can therefore easily find themselves conflicted between the needs of the company and the needs of the scheme. As trustees, they may demand

[24] The NAPF's 2005 Annual Survey revealed that just 30% of respondents pay their lay trustees more than expenses. The mean annual payment was around £7000.
[25] The 2005 NAPF Annual Survey found that 54% of trustees were employer-nominated and a further 35% were member-nominated. From 2009, 50% will have to be member-nominated.

additional contributions and corporate funds which the company may have preferred to earmark for other things[26].

27. A second way by which the new funding regime heightens the risk of conflicts of interest concerns the exchange of information. Finance Directors in particular have confidential information which is clearly relevant to the sponsor's ability to fund the scheme. As trustees, they are legally obliged to share relevant information with other trustees. If they do not disclose confidential information, they may risk a fine (see paragraph 24).

28. The increased risk of conflict of interest[27] has led to some company boards discouraging Finance Directors from becoming a pension fund trustee. But this diminishes the body of financial expertise available to trustee boards and increases the burden on the remaining trustees.

(vi) Implications for the Myners agenda of the transformed world for pensions

29. In summary, the pensions world has changed significantly since 2000/1, when *Institutional Investment in the UK: A Review* was being prepared. DB pensions have been hit by a 'perfect storm' which has had three main consequences for the Myners agenda:

"Defined Benefit pensions have been hit by a 'perfect storm' which has had three main consequences for the Myners agenda."

- The sheer weight of the changes in the proliferation of financial innovation, funding, investments and regulations, has taken the lion's share of the resources of trustees and their advisers. As will be documented in the following section, there has been substantial progress on the Myners agenda, but this has been against a background of a significantly increased volume of Government-prompted regulation which has to compete for schemes' scarce resources.

- The fact that the pensions world is very different from that which prevailed in 2000/01 means that some of the Principles which were written for the environment as it was, appear less relevant. An example is Principle 6, on shareholder activism. The lower the proportion of equities in portfolios, the less the potential impact of shareholder activism (though it remains as important as ever for pension

[26] In 2005 companies made one-off payments to their pension funds of nearly £11bn, five times the amount paid in 2001. In a speech in September 2006 (The Puzzle of UK Investment) Sir John Gieve, a Deputy Governor of the Bank of England, suggested that this might be one reason why the ratio of the value of investment to GDP fell in 2005 to the lowest since 1965.
[27] The Pensions Regulator's clearance guidance provides guidelines to trustees on conflicts of interest and managing these conflicts during any corporate negotiations. See paragraphs 88-91 of Clearance Statements: Guidance from the Pensions Regulator, April 2005.

funds to engage with investee companies). But it is correspondingly more appropriate to manage mismatches in assets and liabilities (eg in duration), an issue on which the Myners Report has little to say, and to ensure that any less liquid investments are carefully planned. Another way in which the Principles may have become less relevant is that the spread of complex financial innovations (for example swaps and derivatives) has inevitably obliged trustees to delegate more – something which runs counter to the spirit of the Principles, which are intended to ensure that trustees have the investment skills to be able to engage with - and if necessary challenge - their advisers and consultants.

- The shift from trust-based DB schemes to contract-based DC schemes means that an increasing number of pensions savers, and a growing pool of pensions assets, will be covered in schemes which are unaffected by the governance issues including effective decision-making and asset allocation that were identified by Paul Myners. This gap in governance will only widen with the introduction of Personal Accounts from 2012, as this will accelerate the trend towards individualised contract-based pension provision and away from trust-based provision.

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?

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?

Question 3:

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

Question 4:

What further developments do you think are relevant to an assessment of progress against the Myners Principles in 2007?

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?

3: Progress with the Principles

30. As noted in paragraph 5, the 2004 Review[28] found that institutional investors had achieved 74-80% compliance rates with a number of the Principles, on the basis of the 'voluntarist' approach proposed in *Institutional Investment in the UK: A Review.*

31. In addition to the voluntarist 'comply or explain' approach of the Principles, some elements of the Myners agenda are being taken forward through legislation or rules:

    - The 2004 Pensions Act (Chapter 35, Part 5, Section 247) laid down for the first time that trustees should have knowledge and understanding of: the law relating to pensions and trusts; the principles relating to the funding of occupational pension schemes and investment of the assets of such schemes; and "such other matters as may be prescribed". The degree of knowledge required is "that appropriate for the purposes of enabling the individual properly to exercise his functions as trustee of any relevant scheme."
    - The 2006 Companies Act contains the reserve power to require financial institutions to disclose the way they have voted at company general meetings.
    - From the start of 2006, FSA rules regarding soft commission came into force.

32. This Section looks at progress on the Principles individually. On the basis of the available evidence, it appears that there has been notable progress. This has been greatest for Principles 3 (asset allocation), 5 (explicit mandates), 6 (shareholder engagement - where there may even be a case for rationalising the many initiatives) and 7 (appropriate benchmarks). There also appears to have been progress on Principle 4 (expert advice). Principle 1 (effective decision-making) does not permit objective measurement but looking at the processes put in place to achieve it (via trustee knowledge and understanding (TKU)), there is notable evidence of improvement. Progress has been slowest for Principle 8 (performance measurement), mainly because there is still no 'best practice' method of assessing investment advisers. For Principle 2 (clear objectives), while there does appear to have been significant progress, there may be a gap between trustee perception and reality. As regards Principles 9 and 10

On the basis of the available evidence, it appears that there has been notable progress on compliance with the Myners Principles.

[28] Myners Principles for institutional decision-making: review of progress, HM Treasury, 2004.

(transparency and regular reporting) it would appear that there has been forward movement but further evidence is needed.

33. The 2004 Review found that compliance with the Principles was significantly lower for DC than for DB schemes. 34% of DB schemes had acted on five or more Principles[29] versus 23% of DC schemes. Progress on implementing the Principles has also been less rapid amongst smaller schemes than larger schemes, as shown in Table 2. This may be because smaller schemes have fewer resources dedicated specifically to pensions and are struggling to meet the new regulatory demands (and related cost pressures) to an even greater extent than larger schemes. The Purple Book recently published by the PPF and TPR confirmed that large schemes are better funded than small ones[30].

Table 2: Proportions (%) of schemes[31] acting on the Principles

Principle	Total	Smaller schemes	Larger schemes
1. Effective decision-making	37	32	54
2. Clear Objectives	51	47	68
3. Asset allocation	52	48	69
4. Expert Advice	34	32	42
5. Explicit Mandates	42	35	67
5. Transaction costs	27	24	40
6. Activism	15	10	32
7. Benchmarks	47	42	67
8. Performance Measurement (of consultant)	21	19	29
8. Performance Measurement (of trustees)	15	13	23

Source: The Myners Principles, Volume 2 of 2: Findings from Quantitative Research, DWP, 2004, p59

[29] The Myners Principles, Volume 2 of 2: Findings from Quantitative Research, DWP, 2004, T4.11, p60.
[30] The Purple Book, The Pensions Regulator & the Pension Protection Fund, 2006, p29. At 31 March 2006, average funding levels (assets divided by liabilities) was 96% for schemes with more than 10,000 members but 78% for schemes with between 100 and 999 members and 81% for the smallest schemes.
[31] Small schemes were defined as those with fewer than 1000 members.

34. A well publicised High Court case in 2001 helped to focus the attention of trustees on the Principles, coming as it did just a few months after their publication. The trustees of the Unilever Superannuation Fund sued Mercury Asset Management (MAM) on the basis that MAM breached its contractual obligation to exercise the highest standards of care and expertise in its management of the Unilever fund and that it had failed to take sufficient account of the risk of underperformance and failed to contain the risk of breaching the downside tolerance contained in the Investment Management Agreement. As the parties reached a settlement, there was no judicial ruling as to the extent of duty of care owed by investment managers to their clients. So there were no precedents set. But the case did focus the attention of trustees on the need to ensure that their attitude to risk is properly documented (relating to Principle 2 on clear objectives) and on the need to monitor their investment managers closely and constantly monitor and review their risk controls (relating to Principle 5 on explicit mandates).

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?

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?

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?

Principle 1 – Effective Decision-Making

35. This Principle states that decisions should be taken only by those with the skills, information and resources to make them effectively. It is the most important of the Myners Principles, since without effective decision-making, it would be difficult for trustees to comply with many of the other Principles. For example, they would not be able to formulate a policy on risk tolerance (as required by Principle 2).

36. Although effective decision-making was the central topic of *Institutional Investment in the UK: A Review*, it does not permit objective measurement. The 2001 Report and the 2004 Review instead examined the processes put in place to achieve it. And

in the 2004 Pensions Act the Government went a step further and legislated for trustees to have the knowledge "appropriate for the purposes of enabling the individual properly to exercise his functions as trustee of any relevant scheme." Trustees in place at 6 April 2006 had until 6 October 2006 to meet this requirement. Newer trustees have six months from their date of appointment to meet it.

In 2005, the level of trustee competence was higher than in 2001.

37. *Institutional Investment in the UK: A Review* reported that 62% of those surveyed had no investment qualifications. In paragraph 43 we suggest that this may have been too pessimistic a statement. But whatever the extent of trustee competence in 2001, the evidence is that by 2005 it was much higher. A study by Oxford University, commissioned by NAPF, found that only 17.6% of the sample of 225 trustees lacked an investment qualification (excluding relevant degrees)[32]. Further, it found that only 5.9% admitted no knowledge/understanding of their Statement of Funding Principles; 1% no knowledge/understanding of asset allocation strategy and 1% no knowledge/understanding of investment strategy. Although the proportion admitting no knowledge/understanding of pension fund law was a little higher – at 8.9% - the general impression remains of a knowledge base which had grown considerably since 2001.

38. However, the bulk of the focus on trustee training appears to have been on DB schemes. For example, a recent survey by The Pensions Regulator reported that 55% of DC schemes had provided no training in the past year versus 33% for DB schemes[33].

39. More evidence that TKU has improved comes from PWC[34] and from Instinet[35]. According to the PWC Survey, the proportion of trustee chairmen who frequently review their trustees' knowledge and understanding and feel that they are taking action to close knowledge gaps rose from 42% in March 2004 to 72% in March 2006. According to Instinet, 63% of funds offered more trustee training in 2004 than in 2001.

40. The improvement in TKU, including that which took place prior to the 2004 Pensions Act, has been accompanied by a number

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32 Trustee Decision-Making in Theory and Practice, NAPF, Sept 2005 see http://www.napf.co.uk/Publications/Downloads/PolicyPapers/SectionI/2005/Trustee_Decision_Making.pdf

33 Occupational Pension Scheme Governance, The Pensions Regulator, September 2006.

34 2nd Survey of UK Pension Scheme Governance, PWC, March 2006.

35 Taking the Temperature of the UK Pension Fund Industry, Instinet, September 2004. The survey was of 101 funds representing 48% of assets held by NAPF members in the UK.

of capacity-building initiatives on the part of the pensions industry and others.

- The Pensions Regulator (TPR) has some 15,000 users of its on-line 'Trustee Toolkit'. Assuming all are trustees, this would be 11.5% of all trustees (there are very roughly 130,000 trustees in total).
- Some 500 trustees a year attend in person at NAPF Trustee courses and conferences. 600 a year test their TKU through the exams set by the Pension Management Institute (PMI), making some 1100 doing exams and attending courses for these two institutions alone.
- The TUC has set up a Member Trustee Network for member-nominated trustees. This provides advice as well as free trustee training. The NAPF and PMI also have trustee networks.

41. In addition there have been many publications designed to build capacity among trustees. Some NAPF examples are "Private Equity and Venture Capital Made Simple – What A Trustee Needs To Know" (2001); "Trustees' Relationships with their Investment Consultants and Advisers" (2005); and "Trustees' Self Assessment of Performance And Assessment Of Third Party Providers: A Guide To Good Practice" (2006). Other examples are Technical News (published by the PMI) and Trustee Guides (published by the TUC). Some actuarial and law firms also publish guides for trustees.

42. In its December 2006 White Paper on the design of the new Personal Accounts, the Government seemed to acknowledge the advance in TKU, pointing to trustees as model pension customers: "In occupational pension schemes, for example, trustees act as informed customers (supported by professional advice) and are able to exert more effective pressure on providers."[36]

"In occupational pension schemes, trustees act as informed customers and are able to exert more effective pressure on providers."

Personal Accounts White Paper, 2006

43. The assessment of TKU in the 2001 Report may have been too pessimistic. It reported[37] that 62 percent of those surveyed had no investment qualifications. However the definition of "investment qualifications"[38] was rather narrow. It did not, for example, include relevant degrees (eg law, accountancy, finance, economics). In fact 45% of trustees surveyed then had a first degree or higher – well above the national average. Although no breakdown by subject is available, if trustees were similar to the national average, around one-third of these – or

[36] Personal accounts: a new way to save, DWP, December 2006.
[37] Page 40.
[38] Page 186.

15% of all trustees – would have a relevant first or second degree. More importantly, it also made no mention of another key element of "effective decision-making", namely, the reservoir of experience among trustees, even though the statistical evidence was collected showing that 31% of the trustees surveyed had ten or more years of experience[39].

44. In 2004 HM Treasury proposed a revision to Principle 1, suggesting that, to assist trustees in the exercise of effective decision-making, funds with more than 5000 members should have access to in-house investment expertise equivalent to at least one full-time staff member. It also proposed that to improve trustee decision-making there should be a strengthening of investment expertise on trustee boards with, in the case of large funds, the Chair of the board and at least one-third of the trustees being familiar with investment issues. The reason for the proposal was to align the Principle with the 2004 Pensions Act as well as to incorporate the 2004 Review's conclusion regarding the importance of investment expertise in the Chair of the board as well as in the trustees themselves. The emphasis on investment expertise in trustee bodies was intended to facilitate effective decision-making.

45. As the proposed revision implies, there is a difference between small schemes and large schemes as regards the level of support for trustees that passes as sufficient to improve effective decision-making. For small schemes, it may be enough to have a pensions manager who organises the relations with investment consultants and managers, and ensures that sufficient information is provided to trustees. In larger schemes, in-house investment staff may be employed. As Table 3 shows, the UK is characterised by a long tail of small schemes.

Table 3: Occupational pension schemes by size

Band – member numbers	Percentage of schemes
2-11	79.3
12-99	11.3
100-999	7.0
1000+	2.3

Source: GAD (2006) Occupational Pensions Schemes 2005

46. Although large schemes generally have access to more investment expertise, it remains likely that most trustee boards have limited access to in-house investment expertise and best

[39] Page 187.

practice should be to consider adding relevant experience to investment sub-committees. The most important category of expertise – in investment strategy – is in short supply but schemes should be able to get second opinions or new ideas from investment banks and some investment managers, although they should be wary that the commercial interest of such advice may not be aligned with their own interests. Expertise to help with manager monitoring is more widely available, though of lesser value.

Assessment of progress on Principle 1: "Effective decision-making" does not permit objective measurement. But the available evidence suggests that opportunities for trustees to gain expertise have grown substantially (though more so in DB than DC schemes). The Myners Report may have been too pessimistic in its assessment of trustee qualifications and experience.

Question 9:

(a) Do you agree with the assessment of progress on Principle 1 (effective decision-making)? 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 1 (effective decision-making) still appropriate?

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

Question 10:

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

Principle 2 – Clear Objectives

47. This Principle suggests that trustees set an investment objective for the fund that takes account of the trustees' attitude to risk, specifically their willingness to accept underperformance due to market conditions. Objectives for the fund should not be expressed in terms which have no relationship to the fund's liabilities, such as performance relative to other pension funds, or to a market index. Trustees of DC funds should be satisfied that they have taken their members' circumstances into account and have offered sufficient options to satisfy the "reasonable return and risk combinations appropriate for most members".

48. This Principle goes to the heart of trustees' responsibilities, requiring them to explicitly declare their level of risk tolerance and articulate their investment beliefs. Many factors will enter into this assessment, for example the trustees' assessment of the strength of the employer commitment and scheme covenant, their view of current market valuations and the relationship between bond and equity yields, the strength of their belief in the equity risk premium and their assessment of its magnitude and the demographics of the relevant pension fund members. The mention in this Principle of trustees' "willingness to accept underperformance due to market conditions" is possibly the first reference in a policy document to the separation of alpha and beta, though this concept has now entered the investment vernacular. It relates to yet another group of issues on which trustees need to have a view – on the potential for alpha and on the portability of alpha, for example.

49. Committing these beliefs to writing should help establish a reference point, a 'sheet anchor'[40] to assist trustees in withstanding the uncertainties and challenges to confidence presented by market volatility. The Marathon Club[41] recommended that trustees draw up an 'Investment Beliefs' document, if necessary planning time together (eg at an offsite meeting). Although advisers could be there as facilitators, the Marathon Club suggested that it was crucial that trustees should draw up the investment strategy themselves - since they would "own" it – rather than delegating this task.

50. HM Treasury's 2004 Review reported that 74% of schemes by scheme membership surveyed had considered and acted upon Principle 2. In March 2006 PWC[42] also reported a high compliance rating on Principle 2. 71% of trustee boards said they had articulated their willingness to accept underperformance and were able to demonstrate that their discussions with the scheme sponsor had resulted in the best available package of options.

Assessment of progress on Principle 2: On the basis of the evidence available, progress would appear to be significant. However there may be a gap between trustees' perception and reality. More evidence is needed.

Question 11:

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[40] A sheet anchor is the heaviest anchor, for use as a last resort in an emergency.

[41] The Marathon Club is a group of approximately 18 senior pension fund managers and advisers, see www.marathonclub.co.uk. It was created as a result of the competition organised by the USS and Hewitt Bacon and Woodrow (January 2004, *op cit*).

[42] 2nd Survey of UK Pension Scheme Governance, PWC, March 2006.

(a) Do you agree with the assessment of progress on Principle 2 (clear objectives)? 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 2 (clear objectives) still appropriate?

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

Question 12:

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

Principle 3 – Asset Allocation

51. This Principle says that asset allocation decisions should receive a level of attention that fully reflects the contribution they can make towards achieving the investment objective; that decision-makers should consider a full range of investment opportunities, not excluding from consideration any major asset class, including private equity; and that asset allocation should reflect the fund's own characteristics, not the average allocation of other funds.

52. HM Treasury's 2004 Review found that 80% of schemes (weighted by membership) had acted on Principle 3. However they commented that this reflected the response of many schemes to changing financial market conditions, rather than to the "more fundamental changes recommended by the Myners review to commit more resources."

The 2004 Review found that 80% of schemes had acted on Principle 3.

53. The pension fund balance sheet data published by the Office for National Statistics provide time series data, but only for the asset classes of bonds, equities and property; there is no data for alternative assets such as private equity and hedge funds. However the ONS data do show that within their equity holdings, pension funds have diversified from UK to international equities. In the ten years 1995-2005 their holdings of UK equities fell from 55.5% of total assets to 36.5% while holdings of non-UK equities rose from 16.8% to 22.8%.

54. Surveys offer further evidence that pension funds are taking a more diversified approach to asset allocation. Data collected for the NAPF's 2006 Annual Survey (forthcoming) show that 19% of respondents said that they invest in private equity/venture

capital (52% when weighted by asset value). This was up from 15% in 2005 and from just 6% in HM Treasury's 2004 Review[43]. 7% say they have increased the proportion of their strategic asset allocation devoted to private equity/venture capital within the past 12 months. 10% of respondents invest in hedge funds (25% when weighted by asset value). This is up from 8% last year. 8% say they have increased the proportion of their strategic asset allocation devoted to hedge funds within the past 12 months.

55. The 2005 JP Morgan Fleming Alternative Investment Strategies Survey of 350 pension schemes revealed that 31% invest in private equity and 12% in hedge funds. A further 26% are considering investment in private equity and 40% in hedge funds. Of the schemes that currently invest in these asset classes, the average allocation is 2.3% to private equity and 5.5% to hedge funds. The WM Company reports a modest growth in the popularity of 'alternative' investments over the past six years. In 2000, an average 0.8% of assets were held in "Other Investments" but by end-2005, this had risen to 2%. At end-September 2006 it had risen further to 2.6%. Property allocation has nearly doubled over the past six years (again according to WM) to 7% and many schemes, including the larger ones, have stated an objective to allocate 10% or more. Once the preserve of the biggest funds, property is now present in 56% of funds and across the size spectrum (excepting the very smallest) exposures have risen since 2000.

Assessment of progress on Principle 3: Based on the available evidence, compliance would appear to be high. Pension funds are taking an increasingly diversified approach to asset allocation.

Question 13:

(a) Do you agree with the assessment of progress on Principle 3 (asset allocation)? 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 3 (asset allocation) still appropriate?

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

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[43] The Myners Principles, Volume 2 of 2: Findings from Quantitative Research, DWP, 2004.

Question 14:

As regards asset allocation, to what extent are schemes looking more widely than in 2001 and are asset allocation and manager structures better designed to achieve scheme investment objectives?

Question 15:

What are the main reasons which have led pension funds to consider/invest in a wider range of assets?

Question 16:

To what extent are pension funds measuring and managing the characteristics and risks of their investments (eg duration, illiquidity, interest rate sensitivity and volatility) relative to the characteristics of their liabilities?

Principle 4 – Expert Advice

56. Principle 4 says that contracts for actuarial services and investment advice should be opened to separate competition. The fund should be prepared to pay sufficient fees for each service to attract a broad range of potential providers. The same provider may be awarded both contracts, provided these have been won in open and separate competition.

57. HM Treasury's 2004 Review found that 48% of schemes (weighted by membership) had considered Principle 4 and acted on it. A diverse picture emerged of the frequency with which schemes change their investment consultants. Almost a quarter (23%) said that their investment consultants had been working with the scheme for less than a year and a similar proportion (21%) responded between one and two years. At the other end of the scale, a further quarter (24%) had been working with the same investment consultant for six years or longer.

58. As noted earlier, input into investment strategy has become more widely available since 2001, with most investment banks and many investment managers offering such advice to plan sponsors, though trustees need to be wary that the commercial interest of such advice may not be aligned with their own interests.

59. In the 2004 Review, HM Treasury widened the areas to be open to separate competition to "actuarial, strategic asset allocation and fund manager selection advice". The aim was to encourage greater competition and diversity of experience in the market for asset allocation advice by drawing fund managers in to tender for these contracts. A number of industry commentators said that while funds should secure more than

one source of advice on asset allocation, to require separate contracts for asset allocation and fund manager selection advice failed to recognise the interdependence of these two areas. The increase in sources of inputs into asset allocation (eg investment banks) reinforces this point.

60. The Morris Review of the actuarial profession[44] which reported in March 2005 (three months after HM Treasury's Review) appeared to take these comments on board, recognising that in some cases it would be cost-effective for trustees to use the same actuary for all three services (actuarial, strategic asset allocation, and fund manager selection advice). However it proposed that if a tender embracing all three was put out to contract, trustees should explain in the statement of funding principles why they did not issue separate tenders. The Morris Review also noted that fewer than 10% of actuarial contracts are re-tendered in any given year. It proposed that Principle 4 be amended to recommend that trustees should put actuarial contracts out to tender at least every six years. A review of actuarial services provided to the fund should be carried out every three years (to coincide with valuations) by a suitably qualified person (who might be a trustee). The Morris Review proposed that every other year an informal evaluation should be conducted.

Assessment of progress on Principle 4: Based on available evidence, it would appear that there is significant progress on this Principle. An appreciable number of funds appear to seek tenders for separate actuarial and investment consulting advice, though there is a lack of very recent data.

Question 17:

(a) Do you agree with the assessment of progress on Principle 4 (expert advice)? 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 4 (expert advice) still appropriate?

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

[44] http://www.hm-treasury.gov.uk/media/CA0/9C/morris_final.pdf

Question 18:
Do you agree with the amendments to Principle 4 proposed by the Morris Review?

Principle 5 - Explicit Mandates

61. This Principle states that trustees should agree benchmarks with their investment managers. Also to be agreed are risk tolerances, the manager's approach and timescales for evaluation, such that the mandate will not be terminated before the expiry of the timescale solely for underperformance. In 2004 the Government suggested a revision to clarify and simplify this Principle, judging that this would increase the onus on the industry to deliver change.

62. HM Treasury's Review found that 75% of Schemes (weighted by membership) had acted on Principle 5. Other indicators also suggest that the respective roles of trustees and advisers are reasonably clear. For example, the NAPF's 2005 Annual Survey[45] found that 84% of respondents' schemes reviewed their fund managers' performance at least every quarter, and that 64% have changed a manager in the past. These findings are not consistent with a lack of clarity as to the respective roles of trustees and advisers. The improvement in trustee training and a more complete assessment of trustee qualifications would point in the same direction. So would the rise in the numbers of professional trustees. The independent professional trustee companies now provide approaching 1,000 trustees, double the number of six years ago.

The number of independent professional trustees has doubled in six years, to approaching 1,000.

63. The Myners Review by HM Treasury in December 2004 noted a finding in the NAPF/IMA Study[46] that most IMA members felt that the structuring of mandates promotes 'short-termism' whereas most NAPF members disagreed. HM Treasury suggested that this difference in perception revealed lack of agreement between managers and trustees over the timescales over which managers' performance will be judged. But in practice, a clash of views about the timescale over which performance should be measured is rarely the direct cause of the termination of a mandate.

64. Most modern mandates are believed to contain a firm timeframe for the performance objective. It is typically three years for a long-only equity mandate. In monitoring the manager, trustees will usually have regard to the manager's business, people, process and risk control as well as performance. The consultant's rating will also be crucial.

[45] Annual Survey Part 2 - Pension Fund Investment, NAPF, 2005.
[46] Short-Termism Study Report, NAPF/IMA, September 2004.

Termination of the mandate will usually be influenced by more than one of these factors, eventually leading to a loss of confidence in the manager and since termination is rarely for performance alone, timescale is not usually an issue. The position might be helped by better dialogue between trustees and managers especially after a termination.

65. Principle 5 also states that "Trustees … should have a full understanding of the transaction-related costs they incur, including commissions…. Trustees should not without good reason permit soft commissions to be paid in respect of their fund's transactions". In March 2005, an IMA/NAPF Joint Working Party updated the Pension Fund Disclosure Code to improve disclosure of the charges and costs levied by managers on pension fund assets[47]. On soft commissions, Myners' recommendation has been fully met where trustees award mandates to FSA-regulated managers. From the start of 2006[48], the FSA rulebook stated that soft commission could only be used for purchases which were related to execution and research.

Assessment of progress on Principle 5: Based on available evidence, it would appear that progress has been significant. The respective roles of trustees and advisers is generally clear. Differing perceptions about time horizons as between trustees and managers may stem from different interests and should not necessarily be seen as detracting from fund performance. The new regulatory regime for soft commissions limits spending of soft commissions to execution and research.

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?

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[47] The Code can be found on http://www.investmentuk.org

[48] There were limited transitionals until 1 July 2006.

Question 20:

What evidence do you have from your own organisation (or from those you represent) that mandates are prematurely terminated for underperformance alone? Do you believe that the perception of this risk detrimentally influences fund manager performance? What changes to Principle 5 might address this?

Principle 6 - Shareholder activism

66. This Principle states that managers should have an explicit strategy on engaging with investee companies, including how they will measure the effectiveness of the strategy. In the 2004 Review HM Treasury suggested substituting the Institutional Shareholders' Committee (ISC) Statement of Principles (see paragraph 69 below) for the US Department of Labor Interpretative Bulletin on activism. This was to remove ambiguity and make clear the responsibility of trustees for ensuring appropriate engagement is undertaken. HM Treasury worked with the ISC on a revised version of the ISC Statement of Principles which was published in 2005.

67. There are four levels of shareholder engagement:

- **Voting.** The voting rate of pension funds at annual general meetings is generally increasing but as voting is usually delegated to investment managers, the responsibility for further increase falls to them, though through voting guidelines and other initiatives (see below) pension funds are facilitating this.

- **The alignment of interests by means of appropriate structures of company boards**. This is also generally delegated, being applied through voting and company AGMs and other meetings.

- **The alignment of interest through appropriate remuneration structures**. Again this is normally delegated. However it can be a source of conflict with institutional investors frequently arguing for a higher proportion of remuneration to be performance-related.

- **The highest level of engagement is through direct oversight of board strategy.** This can range from low-key insights all the way up to company doctoring. In cases of major under-utilisation of resources, investment managers can work with private equity companies to achieve management change. Not all managers can operate at this level of engagement – for example a quantitative manager may not have the relevant skills. For similar reasons, delegation of

this level of engagement to asset managers has an uneven track record.

68. Funds are expected to keep records of how their managers have voted, especially when they vote against the management of a company, and of any dialogue with companies. HM Treasury's 2004 Review showed that schemes covering 51% of members had considered and acted on shareholder engagement, though there was a marked difference between large and small schemes. 32% of larger schemes met the performance standard on Principle 6 versus just 10% of smaller schemes.

There has been increasing clustering around the Statement of Principles of the Institutional Shareholders' Committee.

69. Partly as a result of the 2004 proposed change to Principle 6, there has been increasing clustering around the Statement of Principles of the ISC. The ISC brings together the largest institutional investors. Its members are the Association of British Insurers (ABI); the Association of Investment Companies (AIC); the IMA; and the NAPF. The ISC's Statement of Principles is set out in the box below.

The ISC Statement of Principles

The ISC's Statement of Principles sets out best practice for institutional shareholders concerning their responsibilities in respect of the companies in which they invest. Investors and their agents should:

1. set out their policy on how they will discharge their responsibilities – clarifying the priorities attached to particular issues and when they will take action;
2. monitor the performance of, and establish, where necessary, a regular dialogue with investee companies;
3. intervene where necessary;
4. evaluate the impact of their engagement; and
5. report back to clients/beneficial owners.

70. Both the IMA and the NAPF regularly survey their members to assess progress on engagement with investee companies. The IMA's third Engagement Report (for the year ended 30 June 2005) revealed that 31 of 35 managers had set out their engagement policies in client agreements (up from 30 the previous year). 28 (2004: 26) managers refer to their policies on adherence to the Statement of Principles in new agreements. Further, the majority of managers now employ staff dedicated to engagement and corporate governance and/or SRI (Socially Responsible Investment) issues. These resources have increased by just over 10% a year since 2003.

71. The NAPF's most recent Engagement Survey[49] corroborates this progress. It surveyed 41 of the largest pension funds and found that:

- Nine out of every ten of the funds are familiar with the ISC's Statement of Principles. Six out of ten have implemented the Principles, either directly (in managers' contracts) or through other means.
- More than nine out of ten funds receive regular reports from their fund managers about how votes have been exercised. A similar proportion say that their managers devote more resources to engagement now than they did in 2001, at the time of the Myners Report, and six out of ten say that this resource has increased during the past two years. Seven out of ten receive regular reports of the impact of managers' engagement with companies.
- Half of the 41 have internal resources devoted to engagement and half of these have increased these resources over the past two years.
- Nearly half the 41 funds disclose how they vote, mostly to scheme members on request. (The Government has included a reserve power in the 2006 Companies Act to require financial institutions to disclose how they have voted at company general meetings.)

72. In addition to the work by the ISC, a number of other initiatives have been undertaken since 2001 to improve shareholder engagement.

[49] Pension Funds' Engagement with Companies, NAPF, October 2006.

Engagement Initiatives: ABI, IMA, NAPF and TUC

- In 2002 the NAPF published trustee guides to the Myners Principles, for both DB and DC schemes. It has also published guidance on corporate governance for pension funds (December 2003, revised in November 2006[50]).
- In June 2003, NAPF worked with Institutional Shareholder Services to establish Research Recommendations Electronic Voting (RREV). RREV provides pension funds with corporate governance research, as well as voting recommendations and electronic voting services on UK listed stocks.
- In 2003 and 2004, the NAPF revived its Case Committees which arrange meetings of institutional investors and investee companies in cases of concern. The ABI has an equivalent arrangement.
- The IMA's most recent Engagement Survey showed that all 35 fund managers surveyed had finalised policy statements on engagement (in 2004 one and in 2003 five managers' statements were still in draft). 27 managers promulgate their statements on their website versus 21 in 2004.
- The TUC publishes an annual fund manager voting survey[51]. In the 2006 survey, 26 organisations disclosed how they voted on a number of specific company matters, versus just 9 in 2003. This rise in the response rate suggests that voluntarism is working. The 26 included three of the largest pension funds (British Airways Pensions Management, Railpen and the Universities Superannuation Scheme).

73. There have been a number of high profile cases where shareholder engagement has been clearly seen in action. One example was Shell. In January 2004, Royal Dutch/Shell announced that its financial statements had shown inflated oil reserves in the earlier years and that it would downgrade nearly 4 billion barrels of its 'proven' oil and gas reserves. This announcement was followed by some 30 – 40 meetings of the company with its major institutional investors. Many of these meetings were "case committees", instigated under the corporate governance initiatives described above. The shareholders pointed to the complex and opaque twin-board governance structure as one reason for the company's problems. As a result, in October 2004 Shell announced a merger of the Royal Dutch/Shell Group of Companies under a single parent company.

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[50] http://www.napf.co.uk

[51] Fund Manager Voting Survey, Trades Union Congress, 2006.

74. As a result of an increased focus on engagement, investors believe that corporate governance standards are improving. The NAPF's 2006 Engagement Survey[52] reported that 85% of the UK's largest pension funds agreed with this statement and none felt that standards were deteriorating. This suggests that in this area, voluntarism is working. However, the Government decided in the 2006 Companies Act to retain the power to require financial institutions to disclose voting at company general meetings.

Investors believe that corporate governance standards are improving.

Assessment of progress on Principle 6: On the evidence available, it would appear that progress has been significant. There has been great progress on shareholder engagement, with many corporate governance initiatives undertaken in the past six years. There has been increasing clustering around the Statement of Principles of the Institutional Shareholders' Committee.

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?

Principle 7 – Appropriate Benchmarks

75. This Principle states that trustees should use appropriate benchmarks. HM Treasury's 2004 Review found this to be one of the Principles with the highest compliance, with schemes covering 76% of members acting on Principle 7.

76. Pension funds have almost completely abandoned industry average benchmarks. Less than 4% of UK funds now adopt an industry average benchmark (source Mercer[53]); the vast majority of funds uses scheme specific benchmarks. The WM Company reports a similar rise in scheme-specific benchmarking. According to WM, at end-2005 95% of schemes employed a scheme-specific benchmark, up from 75% at end-

[52] Pension Funds' Engagement with Companies, NAPF, October 2006.
[53] European Institutional Market Place Overview, Mercer, 2006.

2000. WM ceased publishing statistics for its balanced WM2000 benchmark universe at the end of 2004.

Assessment of progress on Principle 7: Based on the available evidence, progress would appear to be significant. Industry average benchmarks have been almost completely abandoned.

Question 22:

(a) Do you agree with the assessment of progress on Principle 7 (appropriate benchmarks)? 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 7 (appropriate benchmarks) still appropriate?

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

Principle 8 – Performance Measurement

77. This Principle says that trustees should arrange for performance measurement of the fund and also measurement of their own procedures and decisions. They should also arrange for an assessment of performance and decision-making of advisers and managers.

78. A 2003 NAPF Survey[54] of the 500 largest NAPF members suggested that performance measurement of trustees and of advisers was rare. HM Treasury's 2004 Review also identified this as one of the Principles on which progress was slowest: schemes covering just 25% of members had arranged for performance assessment of advisers and schemes covering 30% of members had arranged for performance measurement of trustees.

79. To give practical assistance to help trustees meet this Principle, the NAPF has published two guides to help them manage relationships with investment consultants and managers[55]. The first focused on the conceptual and policy-related issues to developing good practice. It introduced the 'balanced scorecard' methodology for investment consultancy and advice. The second develops many of the concepts discussed

[54] Reaction to the Myners Principles, NAPF, March 2003.

[55] Trustees' Relationships with their Investment Consultants and Advisers, NAPF, March 2005 and Trustees' Self-assessment of their Performance and Assessment of their Third Party Providers, NAPF, March 2006, available from the NAPF Bookshop, see http://www.napf.co.uk/publications/index.cfm

in the earlier guide and additionally discusses in detail the practical issues that are integral to implementing a successful performance review programme. It includes a template for a trustee board balanced scorecard and a toolkit to enable trustees to assess their own skills and knowledge.

Assessment of progress on Principle 8: Evidence would suggest that progress has been slow. Although the NAPF has published guides to help trustees, there is as yet no generally accepted methodology for measuring the work done by consultants at manager selection/deselection level or on strategy, in the same way as exists for measuring investment managers.

Question 23:

(a) Do you agree with the assessment of progress on Principle 8 (performance measurement)? 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 8 (performance measurement) still appropriate?

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

Principles 9 & 10 – Transparency and Regular Reporting

80. The December 2004 Treasury Review of Myners Report compliance noted that 53% of schemes documented their approach to the Myners Principles in their Statement of Investment Principles, annual report and accounts, a member bulletin or a statement in board minutes.

81. In order to improve the quality and availability of information provided to members and stakeholders, the 2004 Review proposed that trustees should make available assessments of their own performance to the scheme membership and that trustees should post on a fund website the key information they provide annually to fund members. It proposed that funds with more than 5000 members should have a website dedicated to the fund.

82. Following the 2004 Review, an expert panel was established to assist HM Treasury develop a framework to provide independent reviewing of Myners compliance (Independent

The framework to provide independent reviewing of progress against the Myners Principles is published here for the first time. Your comments on it are invited.

Compliance Review - ICR). The framework is published here for the first time (Appendix 3). The framework recommends that trustees of funds with assets of over £250 million commission an annual report from a suitably qualified reviewer[56]. The first review and at least every third review after that are to be by a person independent of the fund. (This can be the scheme auditor.) Ideally interim reviews are to be conducted by someone external to the fund (ie not a trustee or an employee of the sponsor). The framework proposes that the trustees should agree with the reviewer a procedure for carrying out the review (based on guidance to be produced by the NAPF). The reviewer will offer an opinion as to whether there is reasonable compliance with the Principles, taking account of the circumstances of the scheme. He or she will also suggest how the fund's processes and practices could be further strengthened in order to more effectively implement the Principles. The framework proposes that trustees should publish in their annual report a summary of the review and that the ICR framework should be reviewed after one full cycle[57]; this date can be brought forward if there is evidence that this might be beneficial.

Assessment of progress on Principles 9 & 10: On the basis of the available evidence, it would appear that transparency and regular reporting have improved.

Question 24:

(a) Do you agree with the assessment of progress on Principles 9 and 10 (transparency and regular reporting)? Has behaviour and practice changed as envisaged by the Principles?

(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, are Principles 9 and 10 (transparency and regular reporting) still appropriate?

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

[56] It was recommended that smaller funds should consider commissioning an ICR and it was hoped that over time the uptake by smaller funds would increase as the ICR concept became more embedded.

[57] Four years, allowing for an initial independent report, then two interim reviews, and finally a further independent review.

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?

Choice of Default Fund (DC Principle 4)

83. For Defined Contribution schemes the 2001 Report proposed an extra Principle, on Choice of Default Fund. This (see Appendix) recommended that trustees should ensure that an investment objective is set for the option, to include expected returns and risks. HM Treasury's 2004 Review did not include evidence on compliance with this Principle.

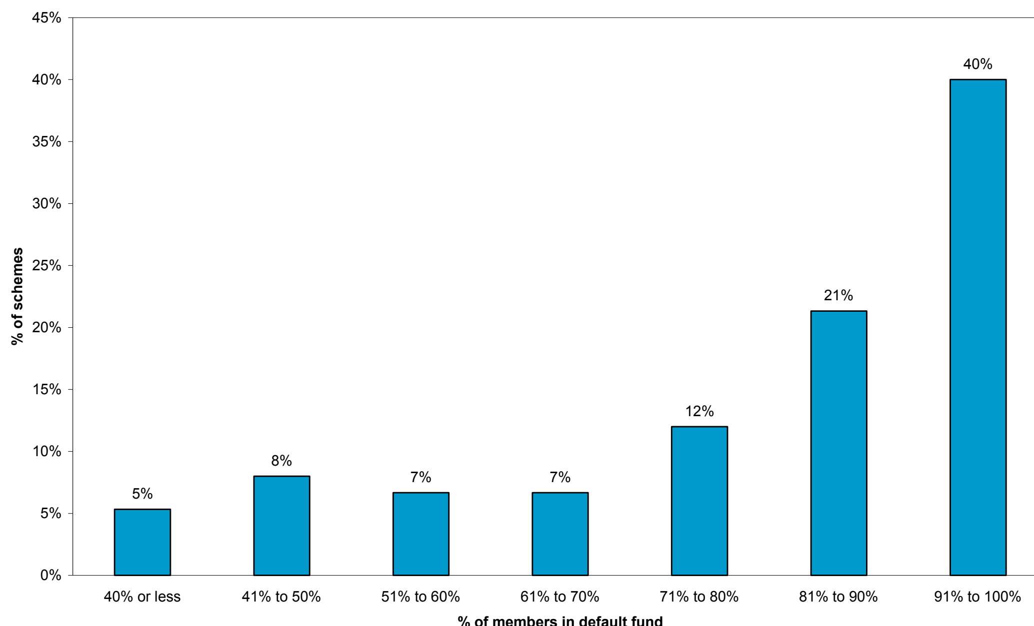
84. The importance of this Principle for DC schemes is underlined by the popularity of the default fund. A 2005 survey by Aon Consulting[58] found that less than a quarter of DC participants select funds other than the default. A recent academic study[59] found that 77% of plan assets in a mid-sized DC fund were invested in the default (balanced) fund. This was 80% invested in equities and 20% in bonds. The alternatives were an "aggressive" fund (90% equities, 10% bonds) and a "conservative" fund (65% equities, 35% bonds). Additionally members over 50 could invest all or part of their assets in a 100% government bond fund.

Less than a quarter of DC participants select funds other than the default.

85. The NAPF's forthcoming Annual Survey for 2006 confirms the popularity of the default fund for DC occupational pension schemes. 76% of such schemes responding have default funds. On average, 81% of the members of such a fund choose or are defaulted into the default fund. If results are weighted by the numbers in each scheme, the average rises to 94%. As Figure 5 shows, 40% of schemes report that more than 90% of members are in the default fund.

[58] DC Pension Provision Report, Aon Consulting, 2005.
[59] Employee Saving and Investment Decisions in Defined Contribution Pension Plans: Survey Evidence from the UK by Alistair Byrne CFA, to appear in the Financial Services Review, Volume 16:1, 2007.

Figure 5: Percentage of Members in the Default Fund



Source: Annual Survey 2006, NAPF (forthcoming).

86. 84% of the schemes with default funds say that the fund is "lifestyled", that is, transfers members' investments into bonds as they approach their expected retirement date. The lifestyling process varies, though. 39% of the schemes with lifestyled default funds say that the shift to bonds starts no more than five years before expected retirement. 46% say it starts at least ten years before expected retirement.

Question 26:

(a) What evidence do you have from your own organisation (or from those you represent) to assess progress on DC Principle 4 (Choice of Default Fund)?

(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 DC Principle 4 (Choice of Default Fund) still appropriate?

4: Conclusion

The evidence surveyed in this Discussion Paper suggests notable progress in compliance by pension funds with the Myners Principles. Progress has been greatest for Principles 3 (asset allocation), 5 (explicit mandates), 6 (shareholder engagement) and 7 (appropriate benchmarks). Indeed regarding shareholder engagement, there may even be a case for rationalising the many initiatives. There has also been progress on Principle 4 (expert advice). Principle 1 (effective decision-making) does not permit objective measurement but there is considerable evidence of improvement in the key process to achieve it, namely, trustee knowledge and understanding. Progress has been slowest for Principle 8 (performance measurement), mainly because there is still no agreed 'best practice' methodology for assessing investment consultants. For Principle 2 (clear objectives), while there does appear to have been significant progress, there may be a gap between trustee perception and reality. As regards Principles 9 and 10 (transparency and regular reporting) it would appear that there has been forward movement but further evidence is needed.

However DC schemes have made less progress than DB schemes in compliance with the Myners Principles. A recent TPR survey found that more than half DC schemes provided no trustee training in the past year versus 33% for DB schemes. And HM Treasury's 2004 Review found that only 23% of DC schemes had acted on more than five of the Principles, versus 34% for DB schemes. Smaller schemes have also shown less compliance progress than larger ones.

The overall progress in compliance suggests that voluntarism has been forthcoming where it has been expected. The progress is all the more welcome, given that it has come at a time when trustees and scheme administrators were confronted by intense change throughout the pensions world. But the changes since 2001 have extended far beyond legislation. Then, many schemes had surpluses and the focus was on how to invest in new areas such as venture capital. But increased longevity and adverse market movements have contributed to scheme deficits and the sensitivity of sponsor companies to this has been raised by the new accounting standards (FRS17/IAS19). Trustees have had to extend their knowledge and understanding to the often complex new financial instruments needed for tackling deficits.

Because of these profound changes, some of the Myners Principles look less relevant now than they did in 2001. They say nothing about the need to manage mismatches in assets and liabilities (eg in duration) and the use of financial innovation to deal with deficits

has obliged trustees to delegate more to advisers, which runs counter to the ethos of the Principles, intended to empower trustees to engage with, and if necessary challenge, advisers and consultants.

Moreover rising longevity, adverse financial market trends and regulatory developments have all driven a reallocation away from equities towards bonds, which implies that the potential impact of an important Principle – on shareholder activism – has declined.

Furthermore, the shift from trust-based DB schemes to contract-based DC schemes means that an increasing number of pension savers and a growing pool of assets will be covered in schemes which are outside the Myners universe.

However, there is a lack of very recent evidence against which to test these conclusions. We will be gathering more data in coming months, including the responses to the questions posed in this Discussion Paper. We greatly look forward to hearing your views.

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?

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?

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?

Question 3:
In the light of experience, what additional Principles might be added or how might the existing Principles be further amended?

Question 4:
What further developments do you think are relevant to an assessment of progress against the Myners Principles in 2007?

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?

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?

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?

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?

Question 9:
(a) Do you agree with the assessment of progress on Principle 1 (effective decision-making)? 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 1 (effective decision-making) still appropriate?

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

Question 10:
Are the 2004 Pensions Act requirements on trustee knowledge and understanding appropriate?

Question 11:
(a) Do you agree with the assessment of progress on Principle 2 (clear objectives)? 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 2 (clear objectives) still appropriate?

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

Question 12:
Do you agree that trustees should set out in writing their collective beliefs, as a 'sheet anchor' to their investment approach?

Question 13:
(a) Do you agree with the assessment of progress on Principle 3 (asset allocation)? 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 3 (asset allocation) still appropriate?

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

Question 14:
As regards asset allocation, to what extent are schemes looking more widely than in 2001 and are asset allocation and manager structures better designed to achieve scheme investment objectives?

Question 15:
What are the main reasons which have led pension funds to consider/invest in a wider range of assets?

Question 16:
To what extent are pension funds measuring and managing the characteristics and risks of their investments (eg duration, illiquidity, interest rate sensitivity and volatility) relative to the characteristics of their liabilities?

Question 17:
(a) Do you agree with the assessment of progress on Principle 4 (expert advice)? 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 4 (expert advice) still appropriate?

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

Question 18:
Do you agree with the amendments to Principle 4 proposed by the Morris Review?

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?

Question 20:
What evidence do you have from your own organisation (or from those you represent) that mandates are prematurely terminated for underperformance alone? Do you believe that the perception of this risk detrimentally influences fund manager performance? What changes to Principle 5 might address this?

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?

Question 22:
(a) Do you agree with the assessment of progress on Principle 7 (appropriate benchmarks)? 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 7 (appropriate benchmarks) still appropriate?
(d) What changes to this Principle (if any) would be desirable to improve governance and investment decision-making by trustees?

Question 23:
(a) Do you agree with the assessment of progress on Principle 8 (performance measurement)? 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 8 (performance measurement) still appropriate?

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

Question 24:
(a) Do you agree with the assessment of progress on Principles 9 and 10 (transparency and regular reporting)? Has behaviour and practice changed as envisaged by the Principles?

(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, are Principles 9 and 10 (transparency and regular reporting) still appropriate?

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

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?

Question 26:
(a) What evidence do you have from your own organisation (or from those you represent) to assess progress on DC Principle 4 (Choice of Default Fund)?

(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 DC Principle 4 (Choice of Default Fund) still appropriate?

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?

Appendix 1: Institutional Investment in the UK – 2007 Review Terms of Reference

In December 2004 HM Treasury asked the NAPF, in 2007, to undertake a further review of progress against the Myners Principles. The terms of reference for this Review are set out below.

Terms of Reference

1. To undertake a review of the compliance of occupational pension funds with the Myners Principles. The review is intended to provide an assessment of the changes in pension fund behaviour and practice which have resulted from the Principles, and in light of this to recommend any changes to the Principles which would improve pension scheme governance and the efficiency of investment decision-making by trustees, and enhance ownership of the Principles by the industry.

2. To undertake the Review in a consultative manner so as to ascertain the views of a wide range of stakeholders. To include Government Departments; occupational pension schemes; the investment and pensions industry; trustees; pension fund members and their representatives; and employer representatives.

3. To evidence progress through: responses received to a Discussion Paper; original quantitative and qualitative research (amongst trustees; occupational pensions schemes and local authority pension funds); and roundtable discussion sessions.

4. To report regularly on progress to the NAPF Investment Council.

5. To complete the Review and present a report with recommendations to HM Treasury by end-October.

6. To keep the timetable under review.

Accountabilities

Accountable to the Chief Executive of the NAPF and the NAPF Investment Council.

NAPF, January 2007

Appendix 2: The Myners Principles [1]

(i) For DB schemes[2]

1. Effective decision-making

Decisions should be taken only by persons or organisations with the skills, information and resources necessary to take them effectively. Where trustees elect to take investment decisions, they must have sufficient expertise to be able to evaluate critically any advice they take.

Trustees should ensure that they have sufficient in-house staff to support them in their investment responsibilities. [Funds with more than 5,000 members should have access to in-house investment expertise equivalent at least to one full-time staff member who is familiar with investment issues]. Trustees should also be paid, unless there are specific reasons to the contrary.

It is good practice for trustee boards to have an investment subcommittee to provide the appropriate focus. [The chair of the board should be responsible for ensuring that trustees taking investment decisions are familiar with investment issues and that the board has sufficient trustees for that purpose. For funds with more than 5000 members, the chair of the board and at least one-third of trustees should be familiar with investment issues (even where investment decisions have been delegated to an investment subcommittee)].

Trustees should assess whether they have the right set of skills, both individually and collectively, and the right structures and processes to carry out their role effectively. They should draw up a forward- looking business plan.

2. Clear objectives

Trustees should set out an overall investment objective for the fund that:

- represents their best judgement of what is necessary to meet the fund's liabilities given their understanding of the contributions likely to be received from employer(s) and employees; and

- takes account of their attitude to risk, specifically their willingness to accept underperformance due to market conditions.

Objectives for the overall fund should not be expressed in terms which have no relationship to the fund's liabilities, such as performance relative to other pension funds, or to a market index.

3. Focus on asset allocation

Strategic asset allocation decisions should receive a level of attention (and, where relevant, advisory or management fees) that fully reflect the contribution they can make towards achieving the fund's investment objective. Decision-makers should consider a full range of investment opportunities, not excluding from consideration any major asset class, including private equity. Asset allocation should reflect the fund's own characteristics, not the average allocation of other funds.

4. Expert advice

Contracts for actuarial services and investment advice should be opened to separate competition. [In 2004 it was proposed that this be replaced by "Funds should contract separately for actuarial, strategic asset allocation and fund manager selection advice and these contracts should be opened to separate competition"]. The fund should be prepared to pay sufficient fees for each service to attract a broad range of kinds of potential providers.

5. Explicit mandates

Trustees should agree with both internal and external investment managers an explicit written mandate covering agreement between trustees and managers on:

- an objective, benchmark(s) and risk parameters that together with all the other mandates are coherent with the fund's aggregate objective and risk tolerances;

- the manager's approach in attempting to achieve the objective; and

[1] The Principles are shown as revised in October 2001 after consultation.

[2] Amendments proposed by HM Treasury in December 2004 are shown in square brackets.

- clear timescale(s) for performance measurement and evaluation, such that the mandate will not be terminated before the expiry of the evaluation timescale for underperformance alone [*In 2004 it was proposed that this be replaced by* "clear timescale(s) for performance measurement and evaluation"].

The mandate and trust deed and rules should not exclude the use of any set of financial instruments, without clear justification in the light of the specific circumstances of the fund.

Trustees, or those to whom they have delegated the task, should have a full understanding of the transaction-related costs they incur, including commissions. They should understand all the options open to them in respect of these costs, and should have an active strategy – whether through direct financial incentives or otherwise – for ensuring that these costs are properly controlled without jeopardising the fund's other objectives. Trustees should not without good reason permit soft commissions to be paid in respect of their fund's transactions.

6. Shareholder Activism

The mandate and trust deed should incorporate the principle of the US Department of Labor Interpretative Bulletin on activism. Managers should have an explicit strategy, elucidating the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy.

[*In 2004 it was proposed that this be replaced by* "Trustees should comply with the Institutional Shareholders' Committee statement of principles on the responsibilities of institutional shareholders and agents, and ensure that the principles are incorporated into fund managers' mandates. In line with the principles, trustees should ensure that managers have an explicit strategy, elucidating the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy"].

7. Appropriate benchmarks

Trustees should:

- explicitly consider, in consultation with their investment manager(s), whether the index benchmarks they have selected are appropriate; in particular, whether the construction of the index creates incentives to follow sub-optimal investment strategies;

- if setting limits on divergence from an index, ensure that they reflect the approximations involved in index construction and selection;

- consider explicitly for each asset class invested, whether active or passive management would be more appropriate given the efficiency, liquidity and level of transaction costs in the market concerned; and

  where they believe active management has the potential to achieve higher returns, set both targets and risk controls that reflect this, giving the managers the freedom to pursue genuinely active strategies.

8. Performance measurement

Trustees should arrange for measurement of the performance of the fund and make formal assessment of their own procedures and decisions as trustees. They should also arrange for a formal assessment of performance and decision-making delegated to advisers and managers.

9. Transparency

A strengthened Statement of Investment Principles should set out:

- who is taking which decisions and why this structure has been selected;

- the fund's investment objective;

- the fund's planned asset allocation strategy, including projected investment returns on each asset class, and how the strategy has been arrived at;

- the mandates given to all advisers and managers;

- the nature of the fee structures in place for all advisers and managers, and why this set of structures has been selected.

10. Regular reporting

Trustees should publish their Statement of Investment Principles and the results of their monitoring [of their own performance and that] of advisers and managers. They should send key information from these annually to members of these funds, [as well as posting this on a fund website,] including an explanation of why the fund has chosen to depart from any of these principles. [It is good practice for funds with more than 5000 members to have a website dedicated to the fund].

(ii) For DC schemes [3]

1. Effective decision-making

Decisions should be taken only by persons or organisations with the skills, information and resources necessary to take them effectively. Where trustees elect to take investment decisions, they must have sufficient expertise and appropriate training to be able to evaluate critically any advice they take.

Where scheme members are given a choice regarding investment issues, sufficient information should be given to them to allow an appropriate choice to be made.

Trustees should ensure that they have sufficient in-house staff to support them in their investment responsibilities. Trustees should also be paid, unless there are specific reasons to the contrary.

It is good practice for trustee boards to have an investment subcommittee to provide the appropriate focus.

Trustees should assess whether they have the right set of skills, both individually and collectively, and the right structures and processes to carry out their role effectively. They should draw up a forward-looking business plan.

2. Clear objectives

In selecting funds to offer as options to scheme members, trustees should:

- consider the investment objectives, expected returns, risks and other relevant characteristics of each fund, so that they can publish their assessments of these characteristics for each selected fund; and
- satisfy themselves that they have taken their members' circumstances into account, and that they are offering a wide enough range of options to satisfy the reasonable return and risk combinations appropriate for most members.

3. Focus on asset allocation

Strategic asset allocation decisions (for example for default and lifestyle options) should receive a level of attention (and, where relevant, advisory or management fees) that fully reflect the contribution they can make towards achieving investment objectives. Decision-makers should consider a full range of investment opportunities, not excluding from consideration any major asset class, including private equity.

4. Choice of default fund

Where a fund is offering a default option to members through a customised combination of funds, trustees should make sure that an investment objective is set for the option, including expected returns and risks.

5. Expert advice

Contracts for investment advice should be open to competition, and fee rather than commission based. The scheme should be prepared to pay sufficient fees to attract a broad range of kinds of potential providers.

6. Explicit mandates

Trustees should communicate to members, for each fund offered by the scheme:

- the investment objective for the fund, its benchmark(s) and risk parameters; and
- the manager's approach in attempting to achieve the objective.

These should also be discussed with the fund manager concerned, as should a clear timescale(s) of measurement and evaluation, with the understanding that the fund mandate will not be terminated before the expiry of the evaluation timescale for underperformance alone.

[3] As regards the amendments proposed in 2004, HM Treasury did not set these out for DC schemes but said that they corresponded to those proposed for DB schemes – see above.

Trustees, or those to whom they have delegated the task, should have a full understanding of the transaction-related costs they incur, including commissions. They should understand all the options open to them in respect of these costs, and should have an active strategy – whether through direct financial incentives or otherwise – for ensuring that these costs are properly controlled without jeopardising the fund's other objectives. Trustees should not without good reason permit soft commissions to be paid in respect of their fund's transactions.

7. Activism

The mandate and trust deed should incorporate the principle of the US Department of Labor Interpretative Bulletin on activism. Managers should have an explicit strategy, including the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy.

8. Appropriate benchmarks

Trustees should:

- explicitly consider, in consultation with their investment manager(s), whether the index benchmarks they have selected are appropriate; in particular, whether the construction of the index creates incentives to follow sub-optimal investment strategies;
- if setting limits on divergence from an index, ensure that they reflect the approximations involved in index construction and selection;
- consider explicitly for each asset class invested, whether active or passive management would be more appropriate given the efficiency, liquidity and level of transaction costs in the market concerned; and
- where they believe active management has the potential to achieve higher returns, set both targets and risk controls that reflect this, giving the managers the freedom to pursue genuinely active strategies.

9. Performance measurement

Trustees should arrange for measurement of the performance of the fund and make formal assessment of their own procedures and decisions as trustees. They should also arrange for a formal assessment of performance and decision-making delegated to advisers and managers.

10. Transparency

A strengthened Statement of Investment Principles should set out:

- who is taking which decisions and why this structure has been selected;
- each fund option's investment objective;
- the default option's investment characteristics, and why it has been selected;
- the agreements with all advisers and managers; and
- the nature of the fee structures in place for all advisers and managers, and why this set of structures has been selected.

11. Regular reporting

Trustees should publish their Statement of Investment Principles and the results of their monitoring of advisers and managers. They should send key information from these annually to members of these funds, including an explanation of why the fund has chosen to depart from any of these principles.

Appendix 3: The Framework for an Independent Compliance Review (ICR)

Introduction

The Myners Principles, published in 2001 and revised in 2004[4], codify best practice for investment decision-making by pension funds. Trustees, on behalf of fund members, are major shareholders in UK companies. They have a key role to play in ensuring that the investment chain - which connects these members to the companies in which their savings are invested - works effectively and that companies are being monitored and held accountable for their performance.

The Myners Principles, which apply on a voluntary "comply or explain" basis, have made a significant difference to the quality of engagement by trustees. However, the Treasury review of progress[5] in implementing the Myners Principles showed that there remained room for improvement and that voluntary disclosure of compliance had not yet achieved the levels, or the richness and depth, envisaged by the original Myners Report.

An expert panel was asked to assist the Treasury develop a framework for an independent review of compliance by pension fund trustees with the Myners Principles.

The aim of this proposed framework is to help further improve the quality of reporting on compliance with those Principles. The intention is that it should form a cost-effective tool to assist trustees to make on-going improvements to their policy and practices in this area, to help disseminate best practice and to provide an assurance to fund members that their pension scheme is applying the Principles appropriately.

Recommendations

The recommendations are as follows:

Objectives

- Through a framework for review of compliance with the Myners Principles, to assist trustees to make on-going improvements to their policy and practices, to help disseminate best practice and to provide an assurance to fund members that their pension scheme is applying the Principles appropriately.

Frequency

- On an annual basis, pension fund trustees of funds with assets in excess of £250 million should commission a report by a suitable person (the reviewer).

Content of review

The review is to assess whether the trustees have taken appropriate steps to ensure that they meet (and will continue to meet) the Myners Principles and to identify any appropriate steps to further strengthen performance.

- The starting point of the review is the trustees' statement of compliance with the Myners Principles in the scheme's Statement of Investment Principles and/or in the scheme's annual report to members. This documents the processes being used and measures undertaken to implement the Myners Principles. The trustees will supplement this by providing the reviewer with appropriate access to other documentation or personnel required to carry out this review and to reach a considered judgement on each issue. The reviewer should note in the report where he or she has insufficient evidence to make such a judgement. It will be the responsibility of the Trustees to make a full and complete disclosure to the reviewer of relevant material.

- The trustees should agree with the reviewer a procedure for carrying out the review based on guidance (to be produced by the NAPF).

- A minority of the Principles permit objective measurement. For the majority, the processes put in place to implement the Principles can be objectively assessed but the outcome cannot.

- The reviewer will assess for each Principle:
  where the Principle can be objectively assessed, if it has been met;

[4] Myners principles for institutional investment decision-making: Review of progress, December 2004
[5] Myners principles for institutional investment decision-making: Review of progress, December 2004

where the Principle cannot be objectively assessed, if there are measures and processes in place to implement the Principle;

if there are appropriate systems and controls in place for consideration of the Principle and checking whether it is being met consistently;

if there is justification for non-compliance.

- The reviewer will offer an opinion as to whether the measures undertaken and processes which the trustees advise they have put in place, and the justifications provided for non-compliance, represent reasonable compliance with the Myners Principles. This opinion should take into account the circumstances of the scheme, to avoid one-size-fits-all application of the Principles.

- The scope of the review is not intended to be onerous, in order to avoid imposing unnecessary costs. In particular, the reviewer will be entitled to reasonably rely on trustees' statements of fact on processes, systems and outcomes. The review is not intended to provide verification or audit of trustees' statements; nor is the reviewer required to verify if the process or system in question is delivering the intended outcome.

- The reviewer will also offer an opinion as to where and how the fund's processes and practices could be further strengthened in order to more effectively implement the Principles and to contribute to improved fund performance. This should be of particular value where the Myners Principles are more open-ended (eg in respect of trustee training or shareholder engagement). Where prior to the completion of a review the fund has undertaken a gap analysis and put in place an action plan to improve performance, the reviewer should comment on the adequacy of that analysis and plan.

- Trustees may also choose to ask the reviewer to comment on contributory factors, such as any consultation undertaken or advice sought by trustees in relation to implementing the Principles, and the adequacy of these decisions.

Reviewer

- The reviewer should be a competent person who is able to produce an informed and objective report.

- The reviewer should note in the report his or her name, qualifications, relevant experience and any connection he or she has to the pension fund.

- The initial review, and at least every third annual review thereafter, should be by a person independent of the fund, to ensure appropriate rigour and external scrutiny.

- For interim reviews, the trustees should still give careful consideration to the degree of independence of the reviewer and explain the reasons for their choice. Ideally, the interim reviewer would not be an in-house staff member or trustee of the fund. However, there will often be a trade-off between the knowledge of a reviewer connected to the fund versus the detachment and rigour (or at least the perception of such) and the cost of an independent review.

- The decision to commission an independent compliance review (ICR) is a voluntary one and this framework should be seen as best practice. Where trustees choose to depart from this framework or the detailed guidance (eg by deciding to use in-house staff to undertake an interim review) an explanation for this decision should be provided.

Publication

- The reviewer will prepare a draft review and discuss this with the trustees. The trustees will in turn consider whether it would be desirable to prepare an action plan (or amend an existing action plan) to deal with any issues identified and to implement more effectively the Principles.

- Trustees should publish, in their annual report, a summary of the reviewer's final report (including identification of the areas, if any, identified for further strengthening) and their action plan, if any. They should also reflect these, where necessary, in their separate Statement of Investment Principles. The emphasis should be to provide assurance that the reviewer has assessed the level of compliance (as asserted by the trustees) and that the areas for improvement have been identified and responded to.

Consultation process

Comments are sought on the following proposals:

1. **The criteria for determining which schemes should be expected to commission a compliance report.**
   In principle, all schemes would benefit from external review of compliance with the Myners Principles and associated suggestions for improvement. However, the cost for smaller funds could be disproportionate. The bulk of scheme assets are held by larger funds and the overall benefit is likely to be concentrated in this subset of funds (notwithstanding that larger schemes are likely to be further advanced in compliance). Accordingly, it is recommended that funds with more than £250 million of assets should commission a compliance report. However, it is expected that smaller funds will consider the costs and benefits and, where appropriate, commission an ICR. It is also hoped that uptake by smaller funds will increase as practice develops and the ICR concept becomes more embedded.

2. **Coverage of review report.**
   It is important that the scope of the review is kept reasonable to avoid unnecessary costs. In part this will be achieved by the review not providing verification or audit of trustees' statements; nor verification of whether processes or systems are delivering intended outcomes. However, it is also the case that the coverage of the review will be relatively broad (compared to the Combined Code, which has nine auditable provisions, the ICR has the equivalent of 30 provisions). The guidance on preparation of the ICR will need careful drafting to achieve an appropriate balance which ensures adequate depth of review at reasonable cost.

3. **Extent of disclosure of the review's findings and form in which provided to scheme members.**
   A balance needs to be struck between conflicting objectives. A report restricted to trustees is likely to be more frank in identifying weaknesses and less prone to boilerplate disclosures. However, this would not provide any accountability to members. Trustees might be more likely to commission a report solely for themselves but this would give them weaker incentives to act than a published document. The appropriate balance would seem to be to provide for the trustees to publish a summary of the report. This should be accurate, balanced and forward-looking. Moreover, the trustees should have the opportunity to prepare and explain to members what they are doing to respond to the issues raised by the report.

4. **Timing of the introduction, frequency and duration of review requirement.**
   It is important that the proposal for an ICR be widely consulted upon to ensure acceptance and uptake. After that, the report should be introduced as soon as practicable. In determining an appropriate frequency, the cost and utility of the report need to be balanced. A fully independent review provides greater accountability but an independent reviewer is likely to know less about the fund than some parties with existing connections to the fund (eg, a retained investment consultant). This specific knowledge can have the benefit of providing both particular insights and lower costs. Accordingly, it is recommended that an independent review should be commissioned triennially, but that in the intervening years an interim review by connected parties should suffice. With regard to the duration of the review requirement, it is recommended that this should be reviewed after one full cycle[6] to determine if the report is meeting its objectives of providing a cost-effective mechanism for enhancing accountability, improving implementation of the Myners Principles and improving the performance of pension funds. This should be bought forward if there is evidence that earlier review would be beneficial.

5. **Appropriate qualifications and experience for the reviewer.**
   The principal requirement for the reviewer is that the trustees believe that the reviewer has sufficient skills and experience in the pension and investment area to advise on the implementation of the Myners Principles. Trustees should have as much flexibility as possible in selection. In many cases, the required skills will found among investment consultants, accountants specialising in pension funds, investment professionals and experienced former trustees.

6. **Appropriate level of independence for triennial reviews and permissible level of connection for interim reviews.**
   At least every third annual review should be by a person independent of the fund, to ensure appropriate rigour and external scrutiny. Trustees are responsible for determining that a proposed reviewer is independent. Independence requires that the reviewer not be connected with the fund, which excludes trustees, employees and contractors. However, an exception is made for the scheme

[6] Four years, allowing for an initial independent report, then two interim reviews, and finally a further independent review.

auditor who should not be considered connected solely by reason of undertaking the audit. This is justified by the existing requirement for auditor independence and the safeguards which govern the provision by auditors of non-audit services. With regard to the permissible level of connection for interim reviews, ideally, the interim reviewer would at least be external to the fund (in other words, not a trustee or an in-house employee). However, there is a trade-off between the knowledge of a reviewer connected to the fund versus the detachment and rigour (or at least the perception of such), and cost, of an independent review. For an interim review, the balance is more relaxed and funds should have substantial flexibility. Trustees should still give careful consideration to the degree of independence of the reviewer and explain the reasons for their choice.

Next steps

It is recommended that, following consultation, the NAPF take ownership of this framework and commission guidance on how it might best be applied.

The attached table identifies those elements of compliance with the Myners Principles which are objectively verifiable and those for which the process can be verified. It is intended to provide an outline for assessing these quantitative and process aspects of the Myners Principles. It is not intended to provide a basis for assessing the qualitative aspects of the Principles. It is envisaged that the expert panel's advice on both the framework and on the quantitative and process aspects of the Myners Principles framework will form the basis for the guidance for the preparation of the ICR.

Partial Regulatory Impact Assessment (RIA)

It is estimated that production of an ICR would incur the following costs for a fund of with assets of between £500 million - £1 billion. An interim review, undertaken by the fund's existing pension consultants and integrated into the existing work programme would take perhaps 2-4 days of consultant time at an estimated cost of £2,000/day (£4,000 - £8,000 pa). The triennial independent review, requiring a more detailed process and more intensive familiarisation with the fund's circumstances would be expected to take 4-6 days, at an estimated cost of £8,000 - £12,000 pa. This gives an average annual cost in the region of £7,500 per annum. This cost represents 0.1 basis points of cost for a fund with an average of £750 million of assets.

While costs are not scalable, it is reasonable to assume that the largest funds (say those with assets of more than £1 billion) would incur a greater cost, given the larger volume of material to be reviewed and the larger scope of potential liability[7]. However, it might well represent a lower percentage of fund expenses than the 0.1 basis points estimated above. The converse would be true of smaller funds with assets in the £250 million - £500 million range. Using the £7,500 as an estimated mid-point, the total annual expenditure on ICRs by the approximately 450 funds covered would be equivalent to £3.4 million pa.

Benefits are not quantifiable to the same degree. However, an important objective of the ICR is the integration of compliance review with the generation of improvement ideas. The proposed alternation between fully independent review and interim review by a reviewer who is likely to have in-depth knowledge of the fund's circumstances is intended to maximise the generation of improvement ideas. If these improvement proposals added an additional 0.001% to investment returns it would cover the estimated cost of the ICR for a fund with assets of £750 million.

Comments are welcomed on this Partial RIA.

[7] The reviewer is to provide an opinion as to whether the measures undertaken and processes which the trustees advise they have put in place, and the justifications provided for non-compliance, represent reasonable compliance with the Myners Principles. He or she is also to advise where and how the fund's processes and practices could be further strengthened in order to more effectively implement the Principles and to contribute to improved fund performance. The reviewer is entitled to rely on information provided by trustees in forming such opinions. The reviewer would in theory be liable for any foreseeable losses suffered by parties to whom a duty of care is deemed to be owed which result from the reviewer's negligence. It is likely that in such cases the reviewer will take steps to limit their liability in negligence to parties who might rely on the opinions offered.

Principle	Detail	Outcome objectively verifiable?	Outcome or process assessment	Improvement proposals
1. Effective decision-making.	Decisions should be taken only by persons or organizations with the skills, information and resources necessary to take them effectively. Where trustees elect to take investment decisions, they must have sufficient expertise to be able to evaluate critically any advice they take.	No.	Reviewer confirm that fund has assessed whether those taking decisions (including trustees) have the skills, information and resources to take them effectively.	
	Trustees should ensure that they have sufficient in-house staff to support them in their investment responsibilities.	No.	Reviewer confirm that fund has assessed whether they have sufficient in-house staff to support them.	
	Trustees should also be paid, unless there are specific reasons to the contrary.	Yes.	In cases where trustees are not paid, reviewer confirm that fund has considered the matter and given specific reasons for not paying trustees.	
	It is good practice for trustee boards to have an investment subcommittee to provide appropriate focus.	Yes.		
	Trustees should assess whether they have the right set of skills, both individually and collectively, and the right structures and processes to carry out their role effectively.	No.	Reviewer confirm that fund has assessed whether those taking decisions (including trustees) have the skills, information and resources to take them effectively.	
	They should draw up a forward-looking business plan.	Yes.		

Principle	Detail	Outcome objectively verifiable?	Outcome or process assessment	Improvement proposals
2. Clear objectives.	Trustees should set out an overall investment objective for the fund that: Represents their best judgement of what is necessary to meet the fund's liabilities, given their understanding of the contributions likely to be received from employer(s) and employees; and	Partially.	Reviewer confirm that fund has an investment objective and that the trustees have assessed whether overall investment objective is consistent with fund's liabilities, given understanding of contributions.	
	Takes account of their attitude to risk, specifically their willingness to accept underperformance due to market conditions.	No.	Reviewer confirm that fund has assessed attitude to risk and its consistency with investment objective.	
	Objectives for the overall fund should not be expressed in terms which have no relationship to the fund's liabilities, such as performance relative to other pension funds, or to a market index.	Partially.	Reviewer confirm whether the objective is expressed in relative terms or not.	
3. Focus on asset allocation.	Strategic asset allocation decisions should receive a level of attention (and, where relevant, advisory or management fees) that fully reflect the contribution they can make towards achieving the fund's investment objective.	No.	Reviewer confirm that fund has assessed its requirements for strategic asset allocation decisions, based on the contribution they make towards achieving investment objectives.	
	Decision-makers should consider a full range of investment opportunities, not excluding from consideration any major asset class, including private equity.	Partially.	Reviewer confirm that fund has assessed a designated range of investment opportunities.	

Principle	Detail	Outcome objectively verifiable?	Outcome or process assessment	Improvement proposals
	Asset allocation should reflect the fund's own characteristics, not the average allocation of other funds.	Partially.	Reviewer confirm that fund has determined required characteristics and these are reflected in the asset allocation.	
4. Expert advice.	Contracts for actuarial and investment advice should be opened to separate competition.	Yes.		
	The fund should be prepared to pay sufficient fees for each service to attract a broad range of kinds of potential providers.	No.	Reviewer to confirm that the fund has assessed the appropriateness of fee levels.	
5. Explicit mandates.	Trustees should agree with both internal and external investment manager(s) an explicit written mandate covering agreement between trustees and managers on: • an objective, benchmark(s) and risk parameters that together with all the other mandates are coherent with the fund's aggregate objectives and risk tolerances; • the manager(s)' approach in attempting to achieve the objective; • clear timescale(s) for performance measurement and evaluation, so that the mandate will not be terminated before the expiry of the evaluation timescale for underperformance alone.	Partially.	Reviewer to confirm that fund has assessed whether objective, benchmark etc together are coherent with the fund's aggregate objective and risk tolerances, and that the relevant areas of agreement have been considered by trustees and include din explicit written mandates.	

Principle	Detail	Outcome objectively verifiable?	Outcome or process assessment	Improvement proposals
	The mandate should not exclude the use of any set of financial instruments, without clear justification in the light of the specific circumstances of the fund.	Partially.	Reviewer to confirm that fund has assessed range of appropriate financial instruments.	
	Trustees, or those to whom they have delegated the task, should have a full understanding of the transaction-related costs they incur, including commissions. They should understand all the options open to them in respect of these costs and should have an active strategy – whether through direct financial incentives or otherwise – for ensuring that these costs are properly controlled without jeopardising the fund's other objectives. Trustees should not without good reason permit soft commissions to be paid in respect of their fund's transactions.	Partially.	Reviewer to confirm investigation of transaction-related costs and existence of strategy for controlling these. Reviewer to confirm that soft commissions are not paid or that fund has considered and provided an explanation.	
6. Activism.	The mandate and trust deed should incorporate the principle of the US Department of Labor Interpretative Bulletin on activism.	Yes.	Reviewer can confirm incorporation of the relevant principle in mandates and trust deed. (Where the ISC Principles are used, the reviewer can confirm that trustees assess compliance with the ISC Principles and have incorporated the ISC Principles into mandates.)	

Principle	Detail	Outcome objectively verifiable?	Outcome or process assessment	Improvement proposals
	Trustees should also ensure that funds have an explicit strategy, elucidating the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy.	Yes.	Reviewer to confirm that fund has an explicit strategy on activism, covering relevant areas.	
7. Appropriate benchmarks.	Trustees should: explicitly consider, in consultation with their investment manager(s), whether the index benchmarks they have selected are appropriate; in particular whether the construction of the index creates incentives to follow sub-optimal investment strategies;	No.	Reviewer to confirm that fund has assessed appropriateness of index benchmarks.	
	if setting limits on divergence from an index, ensure that they reflect the approximations involved in index construction and selection;	No.	Reviewer to confirm that fund has assessed limits on divergence from index (and whether these reflect approximations involved in index construction and selection).	
	consider explicitly for each asset class invested whether active or passive management would be more appropriate given the efficiency, liquidity and level of transaction costs in the market concerned; and	No.	Reviewer to confirm that fund has considered appropriateness of active or passive management.	

Principle	Detail	Outcome objectively verifiable?	Outcome or process assessment	Improvement proposals
	where they believe active management has the potential to achieve higher returns, set both targets and risk controls that reflect this, giving managers the freedom to pursue genuinely active strategies.	Partially.	Reviewer to confirm that fund has set targets and risk controls for active managers. Reviewer to confirm that fund has assessed whether its targets and risk controls give managers sufficient freedom to pursue such active strategies.	
8. Performance measurement.	Trustees should arrange for measurement of the performance of the fund and make formal assessment of their own procedures and decisions as trustees.	Yes.		
	They should also arrange for a formal assessment of performance and decision-making delegated to advisers and managers.	Yes.		
9. Transparency.	A strengthened Statement of Investment Principles should set out: • who is taking which decisions and why this structure has been selected; • the fund's investment objective; • the fund's planned asset allocation strategy, including projected investment returns on each asset class, and how the strategy has been arrived at; • a summary of the mandates given to all advisers and managers; and • the nature of the fee structures in place for all advisers and managers, and why this set of structures has been selected.	Yes.		

Principle	Detail	Outcome objectively verifiable?	Outcome or process assessment	Improvement proposals
10. Regular reporting.	Trustees should publish their Statement of Investment Principles and the results of their monitoring of their own performance and that of advisers and managers.	Yes.		
	They should send key information from these annually to members of these funds, including an explanation of why a fund has chosen to depart from any of these Principles.	Yes.		

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