NAPF

Securing the future of pensions

Institutional Investment in the UK: six years on

November 2007

Report and recommendations

Contents

Foreword

This report sets out the findings and recommendations resulting from the year-long review of the Myners' Principles undertaken by the NAPF. The NAPF was pleased to take on this review, which is an important step in ensuring greater industry ownership of the Principles.

Our task was to assess the extent to which, six years on from their publication, pension fund trustees are applying the Principles; the extent to which scheme governance and the quality of trusteeship have improved; and whether the gaps identified in 2004 have been closed. In the light of the evidence gathered in the course of the review, we were asked to make recommendations to HM Treasury setting out changes to the Principles that would improve pension scheme governance and the efficiency of investment decision making. At HM Treasury's request, we also consulted on proposals for a framework for a mandatory independent compliance review (ICR) to help improve reporting on compliance with the Principles.

The recommendations set out in this report provide a framework for developing further the Principles so that they remain relevant for the world in which pension fund trustees operate today – a world which has changed considerably since the Principles were first published in 2001. It is the view of the NAPF that the changes we have proposed will ensure that standards of scheme governance and investment decision making continue to rise. We look forward to developing our recommendations further with HM Treasury and the wider pensions and investment industry.

From the outset the NAPF was keen to consult with, and ascertain the views of, a wide range of stakeholders. I am very grateful to all those pension funds, trustees, advisers, investment managers and representative bodies that have taken the time to respond to the NAPF's Discussion Paper, or participate in a Round Table or quantitative research. I would also like to thank IFF Research which conducted the trustee research which has informed much of this report.

In particular, NAPF is grateful for the guidance of the Myners Working Group whose members were: Arno Kitts; Gerry Degaute; Giles Craven; David Hobbs; Andrew Kirton; Julian Le Fanu; Nicola Mark; David Morgan and Lindsay Tomlinson.

Joanne Segars
Chief Executive

NAPF
Securing the future of pensions

1. Executive Summary

Summary:

- Since the Principles were first published, and even since HM Treasury undertook its Review in 2004, trusteeship has become more complex – the result of a harsh financial environment and a rising regulatory burden.
- There has been an increase in compliance across all 10 Principles, but progress has not always been even. There are no significant 'market failures'.
- There has been a step change in trustees' knowledge and understanding.
- The Principles remain relevant, but are in need of refreshing to ensure they continue to reflect best practice and take account of legislative, regulatory and market developments since 2001. There is also scope to simplify and consolidate the Principles.
- Targeted help and support are needed to tackle areas of under-compliance, notably trustee self assessment and small schemes.
- The Principles should continue to be based on the voluntarist approach but with additional comply or explain reporting for schemes with assets in excess of £250 million in place of a mandatory Independent Compliance Review.

The story so far

In March 2000, HM Treasury commissioned Paul Myners to undertake a review of institutional investment in the UK[1]. The review was set up to examine whether institutional investors were being unduly restrictive in their asset allocation, particularly in regard to investment in private equity. However, in the course of its enquiries it identified a number of weaknesses in the governance and decision making processes of institutional investors in general, and occupational pension funds in particular, which were found to be detrimental to the interests of scheme members and sponsors and a cause of inefficiencies in the capital market. In the light of these deficiencies, Paul Myners recommended that pension fund trustees[2] adopt a voluntary set of principles to improve pension fund governance and investment decision making.

The response by pension schemes to the Principles was assessed by HM Treasury in 2004[3]. It found that action was being taken on a voluntary basis in a number of areas – around 70% of schemes reported they were fully or mostly compliant with the Principles in aggregate. Significant progress had also been made on Principles

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1 *The report* Institutional Investment in the UK: a review *was published by HM Treasury in 2001.*

2 *Throughout this report we use the term trustee to refer to all those charged with the governance of pensions, whether individual trustees, trustee directors or elected members of local authority schemes.*

3 *Myners Principles for institutional decision-making: review of progress, HM Treasury, 2004*

relating to asset allocation, clear objectives and appropriate benchmarks. However, in a number of other areas progress was lagging. Areas of particular concern were: the skills and expertise and resourcing of trustees; performance measurement and reporting; clarity of investment time horizons; shareholder engagement; and clarity of the role and relationships of trustees and investment consultants. The degree of attention paid by trustee boards to investment matters (such as the resourcing of the asset allocation process) was also a matter of concern. In view of the perceived weaknesses HM Treasury concluded that the original Principles should be strengthened and amplified if pension funds were to serve the interests of their members and sponsors in the way envisaged by Paul Myners. Consequently, a number of amendments were proposed and consulted on, but never formally incorporated.

Following the 2004 review, and in response to the Government's wish that the industry should take greater ownership of the Principles and continue to improve its implementation of them, the NAPF agreed to undertake a further review of compliance during 2007.

2007 Review: the context

Much has changed for occupational pension schemes since the Principles were published in 2001. Even in the three short years since HM Treasury last reviewed the Principles, the pressures on trustees in areas unconnected to the Principles have increased significantly:

- **Scheme funding crisis:** In 2001 around half of all schemes were in surplus. By the middle of 2007, scheme deficits for FTSE 100 companies stood at £21 billion[4].

- **Increased burden of legislation:** Since 2001 over 400 sets of pensions regulations have been published, all of which have impacted on trustees to varying degrees. And since 2004 a new regulatory landscape has come into force, requiring not only that trustees have a higher level of trustee knowledge and understanding, but also that they have a better understanding of the strength of the sponsoring employer and take a pro-active role in corporate transactions to protect the position of the scheme and its members. This alone has elevated the position of trustees in the eyes of corporate sponsors.

- **Rising scheme liabilities:** Unfavourable market trends (falling equity prices and bond yields); the crystallisation of benefit improvements (some awarded during the era of surpluses, others imposed by regulation); and

[4] *Watson Wyatt Pension Deficit Indices*

increased longevity have combined to inflate scheme liabilities, which have translated into higher scheme costs: during 2005 alone, rises in life expectancy forecasts were estimated to have added £20 billion to companies' pension liabilities[5].

- **Scheme closures and the rise of DC:** Since the Principles were first published, there has been a significant change in the way pensions are provided in the UK. Only around a third of DB schemes are still open to new members and all available statistics point to there now being more active members in private sector DC schemes than in private sector DB schemes[6].

These changes – plugging scheme deficits; assessing the strength of the sponsor covenant; taking an increased role in corporate decisions in the event of take-overs; and dealing with legislative change (for example ensuring schemes were ready for the A Day tax changes) – have dominated trustee agendas for the past several years. And their immediacy means they have often taken priority over other issues.

Moreover, the changes in the pensions landscape call into question the continuing relevance of some of the Principles (as currently framed) to today's pensions environment.

2007 Review: progress report

Despite the huge volume of change experienced by pension schemes and trustees over the last six years, trustees have continued to apply and comply with the Principles. It is clear that the Principles have become "accepted wisdom" and in many of the key areas identified in the original review as being weaknesses (and in 2004 as areas where progress had not been sufficient) there has been a 'step change' in compliance and trustee competence. There is considerable support for the continuation of the voluntarist 'comply or explain' approach.

In order to assess compliance, the NAPF adopted a consultative approach and sought the views of a wide range of stakeholders. Consequently, the review has been based on a substantial body of evidence, including the views of trustees themselves.

Significant progress has been made across all ten Principles. Progress has been particularly strong in the following areas: trustee knowledge and understanding (Principle 1); asset allocation (Principle 3); expert advice (Principle 4); appropriate

5 KPMG News, May 2006

6 Combining National Statistics and DWP figures suggests a figure of at least 3.6 million as against 3.4 million in 2006.

benchmarks (Principle 7); transparency and reporting (Principles 9 and 10); and, for larger schemes, activism (Principle 6).

Our research also shows that many of the weaknesses identified in HM Treasury's 2004 Review of compliance have been addressed.

On the key Principle of effective decision making, which underpins much else at the heart of the original Review's findings, there is general agreement that trustees' knowledge and understanding (and hence their ability to make effective decisions) have improved considerably. Almost all trustees surveyed by NAPF report having a good or reasonable understanding of the Principles; almost all trustees report that they have a good or reasonable knowledge of pensions and investment issues. The weaknesses identified in the 2004 Review with regard to effective decision making would appear to have been significantly addressed.

Action has been most forthcoming from larger schemes, reflecting the internal resources and access to advice available to these schemes. Local authority schemes have also continued to make progress in applying the Principles. In the case of local authority schemes, there are now additional regulatory requirements relating to the Principles[7].

However, progress has not been even. For some Principles (or sections of Principles), and for some scheme types, progress has been less rapid.

- **Trustee self-assessment:** Whilst trustees have made significant progress in assessing the performance of their advisers, in particular investment managers, they remain reluctant to assess their own performance.

- **Small schemes:** In its 2004 Review, HM Treasury found much lower levels of Myners take-up amongst smaller schemes compared to larger schemes. Based on the evidence gathered in this review, this remains the case today. Small schemes are even more constrained, in terms of both internal resource and access to expert advice, than their larger counterparts. Moreover, smaller schemes generally cannot access the investment efficiencies that come with scale. This issue will need to be tackled in the next phase of the Principles' development.

The changes since 2001 (both in terms of their volume and immediacy) may go some way towards explaining why progress has been slower in some areas.

7 Local Government Pension Scheme (Management and Investment of Funds) Regulations 1988, as amended in 2002.

Conclusions and recommendations

The evidence gathered in the course of this Review shows that trustees have continued to make progress in applying and complying with the Principles. Many of the weaknesses identified in 2001 and 2004 have been largely addressed. Standards of pension fund governance and decision making have improved and the investment chain is now functioning more efficiently.

The consultative exercise also shows considerable support for the Principles which are seen as having changed schemes' behaviour and approach to governance and investment. However, there was a widely held view that the Principles are in need of updating and consolidating. And given the changes that occupational pension schemes have undergone since 2001 (and even since the HM Treasury review in 2004) respondents did not consider it appropriate simply to adopt HM Treasury's proposed 2004 amendments. A further recurring theme was that the Principles should be exactly that – Principles. There was a view expressed by a number of contributors that some of the Principles were, in fact, about implementation rather than points of high level principle.

Nonetheless, there remain areas where the Principles have not been applied in the way they might have been. In some cases, there may be plausible reasons why: by their very nature, small schemes have less access to advice and scale efficiencies; and trustees of schemes of all sizes and types have had a lot to cope with over the last six years. Our recommendations set out a framework for targeted interventions to address those areas where further progress is needed to ensure continued improvements in pension scheme governance.

Our recommendations to HM Treasury, summarised below, provide a framework for developing the Principles. We look forward to working with HM Treasury, The Pensions Regulator and others in the industry to develop the Principles for today's pensions environment.

Box 1: Summary of recommendations

Summary:

Recommendation 1: Voluntarism should remain at the heart of the Principles, reinforced by a strengthened 'comply or explain' approach to reporting. The current voluntary regime is working well and has secured a high level of compliance. There is scope to adopt a strengthened 'comply or explain' framework in relation to trustees' disclosure of compliance with the Principles.

Recommendation 2: The current Principles should be replaced with fewer, higher-level, Principles for today's pensions environment. The current Principles should be slimmed down to six high level Principles that are relevant to the challenges trustees face today.

Recommendation 3: High level Principles should be supplemented by supporting guidance and toolkits to give trustees practical support. The slimmed down Principles should be supported by practical guidance for schemes and trustees. The industry has a leading role in producing and facilitating this guidance, and ensuring its consistency with the overarching Principles.

Recommendation 4: New approaches are needed to help smaller schemes comply with the Principles. There should be further work and consultation on how small schemes can best implement the Principles, including the options available to introduce scale economies to small schemes.

Recommendation 5: TPR should work with pension schemes, trustees and providers to take forward its proposals in relation to the governance of DC schemes. The rise of DC schemes presents new governance challenges which TPR should address. Principles for DC schemes should also be refreshed to ensure they are relevant to today's environment.

Recommendation 6: The Principles should be co-owned by TPR and the Pensions Industry. Ownership of the Principles should pass from HM Treasury. To ensure both effective industry ownership and a joined-up regulatory framework, the Principles should be jointly owned by TPR and the pensions industry.

Recommendation 7: Trustees should periodically undertake formal assessments of their own performance and that of the Board. Trustees of schemes with assets in excess of £250 million should undertake periodic reviews of their own performance and report on it to members in the annual report and accounts.

Recommendation 8: A further, targeted review should take place in three years. The review should focus specifically on those areas of under-compliance identified in this review as well as the continuing relevance of the Principles.

2. Occupational pensions 2001-2007: the perfect storm

Summary:

- The environment within which occupational pension schemes are operating has changed very considerably since 2001.
- Pension scheme governance has become more complex.
- Many of the original Principles are now enshrined in legislation or quasi legislation.

The environment in which pension funds are operating has changed greatly since 2001. Then, many schemes were considering how to distribute surpluses and the Government's main concern was to consider whether there were factors distorting the investment decision-making of institutions and to remove barriers to the expansion by investors in to new areas, for example private equity. Within just six years, that scenario has been turned on its head. Now the main concerns for trustees are deficit correction, the strength of sponsor covenants, scheme-specific funding, reducing the volatility of funding levels and contributions, and the shift from DB to DC pension provision. Encouraged by The Pensions Regulator (TPR), trustees have begun to think of the pension fund as an unsecured creditor of the scheme sponsor. This has helped 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 2001 trustees have had to cope with:

- the move from scheme surpluses to deficits, primarily the result of financial market developments and increased longevity but made more obvious by accounting changes;

- the continued closure of defined benefit schemes to new members, and in some cases to future accruals – today, only a minority of private sector DB schemes are open to new members;

- a new regulatory regime introduced in the Pensions Act 2004 incorporating changes to trustee skill and expertise requirements themselves deriving from the Myners Review; and

- an increased regulatory burden – two major pieces of pensions legislation (the Pensions Act 2004 and the Finance Act 2004) generated over 100 sets of regulation or Codes of Practice.

These changes have affected how trustees have approached their role, in many cases reinforcing behaviour and stimulating the development of expertise that the Principles aimed to encourage – for example, a clearer focus on objectives and increased interest in strategic advice – but at the same time making their task more complex and difficult.

The changes in the environment in which pension funds now operate have greatly increased the burden on trustees. At a roundtable organised by NAPF to validate the results of the quantitative and qualitative analysis, trustee chairmen estimated that the time commitment for trustees was likely to be around 20 days a year (including structured training, but excluding preparation) and could be more if there were exceptional reviews that had to be handled. This compares with a commitment of about 8 days a year in 2001. The emergence of scheme deficits and greater regulatory obligations have increased their burden of responsibility, while increased diversification of asset classes and the development of new financial strategies and instruments have increased the demands made on their knowledge and understanding.

Six years on from the original Report, pension schemes responding to NAPF's Discussion Paper highlighted the following as key issues in pension fund governance:

- regulatory issues, with the formation of The Pensions Regulator and the Pension Protection Fund;
- the shifted focus of investment strategy from peer performance to scheme specific strategies;
- the relationship with the employer, particularly in relation to the sponsor covenant;
- the increased burden on trustees;
- the increased complexity of investment decisions;
- the need to develop methodologies for implementing and monitoring risk budgets;
- the need to develop methodologies for evaluating advisers and trustees; and
- managing the shift from DB to DC.

One of the local authority schemes summarised the key issues as providing for members' pension requirements, achieving relative stability in contributions by employers, and conducting the business of the fund in a socially responsible manner. A more detailed list of the issues that a trustee needs to understand, provided by one of the private sector schemes, is shown in the box on the next page.

Box 2: a trustee specification – one pension scheme's summary of what is required of a trustee

- A clear understanding of the Trust Deed and Rules and the strategic plan (business plan).
- A clear understanding of the relationship between the trustees and the plan sponsor(s).
- A clear understanding of the sponsor's attitude to risk.
- A clear understanding of the roles and responsibilities of the various advisers and how they fit together for the benefit of the fund.

… and for schemes with an Investment Committee

- An ability to understand the issues involved in the use of new financial strategies and instruments.
- An ability to put this knowledge to good use in challenging advisers and investment managers.
- An ability to understand how a decision on one investment manager or one asset class can impact the balance of the fund's investment manager and asset allocation structure and to learn to make those decisions carefully.
- An ability and willingness to say no to investment banks or investment advisers.

Investment consultants and advisers tended to reply at a more specific level of detail but the issues identified were essentially the same: decision making in a more complex regulatory and market environment, issues of strategy and risk against a background of a greater focus on liabilities, the increased demands on trustees, the relationship with the scheme sponsor and the need to assess the sponsor covenant, potential conflicts of interest, levels of expertise and issues related to delegation and control of investment advisers and managers.

Since the publication of the Myners Report, there has been a considerable change in the environment in which pension schemes have had to operate, which has made the role of trustees much more complex. Pension schemes have been forced by the new environment to improve their governance arrangements, altering their behaviour in the directions envisaged by the Myners Principles, many of which are now covered by regulation. In its response to the NAPF's Discussion Paper, The Pensions Regulator noted that the objectives of the Principles advocating good governance practices – particularly Principle 1 (effective decision making), Principle 4 (expert advice and management of outsourced arrangements), Principle 5 (explicit mandates) and Principle 10 (reporting) – will be further strengthened by work that it is undertaking or has planned. Since 2001 local government pension schemes, which are subject to a statutory rather than a trust-based legislative framework, have been required to adopt a 'comply or explain' approach to the Myners Principles through their Statement of Investment Principles[8].

8 Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998, amended 2002.

3. 2007 progress report

Summary:

- Across all the Principles **compliance has increased**. Whilst progress has not always been even, there are no systemic weaknesses.
- In **trustee decision-making**, which is core to effective trusteeship and which underpins the other Principles, significant progress has been made. **Shareholder engagement** has also become core to schemes' activities, especially large schemes.
- The **Principles have been a catalyst for change** in a number of schemes.
- The **Principles remain relevant – but require amending**.

Six years on from their publication and three years on from HM Treasury's last Review, the 2007 NAPF Review sought to assess:

- the extent to which UK pension funds were applying the Principles;
- improvements in the quality of pension fund governance and investment decision making;
- whether the gaps identified in the 2004 review have been closed; and
- the continuing relevance of the Principles in light of the significant changes that have occurred to the regulation and operation of occupational pensions since 2001.

Evidence on change: methodology

The NAPF has adopted an open and consultative approach to the Review. We have sought the views of as wide a group of stakeholders as possible in the time available. Consequently, the Review has been based on a substantial body of evidence. This has been gathered in a number of ways.

- **Discussion Paper:** In January 2007 the NAPF published a Discussion Paper[9] which sought the views of stakeholders on the Principles. Responses were received from 47 organisations (including 19 pension schemes with assets totalling £144 billion) and individuals from all sectors of the occupational pensions sector. A full list of respondents is given in **Annex A**.

- **Trustee research:** The qualitative research was supplemented by a quantitative survey of the views of 278 trustees, drawn from a cross section of schemes, who were interviewed by telephone between April and

9 *Institutional Investment in the UK: six years on a Discussion Paper from the NAPF, January 2007*

July 2007. This element of the evidence gathering process was conducted on the NAPF's behalf by IFF Research.

- **Round Tables**: To provide further granularity to our evidence, NAPF held a number of Round Table meetings for local authority pension funds and chairs of trustee boards. In addition, the Economic Secretary to the Treasury, Kitty Ussher MP, hosted a meeting at No 11 Downing Street with a range of stakeholders.

- **Bi-lateral meetings:** Bi-lateral meetings have been held with the Institutional Shareholders Committee, the TUC, CBI, The Pensions Regulator, CLG and HM Treasury.

Progress overall

In 2004 HM Treasury concluded that "there was a long way to go if the Principles are to produce the genuine change in behaviour that Paul Myners sought". Three years on, the evidence gathered in this Review paints an overall picture of increasing compliance: trustees are now taking their duties more seriously than ever before; they are acquiring the skills and expertise necessary to be effective decision makers; and are more engaged and diversified investors. The Principles appear to have become "accepted wisdom" for pension schemes and those charged with their governance.

Significant progress has been made across all the Principles. However, as the research shows, compliance is stronger in some areas than others and amongst some scheme types than others. Pension funds in both the public and private sectors, investment managers, advisers and member bodies all agree that compliance with the Principles is now higher than it was in 2004. The Principles have also been a catalyst for change:

Box 3: The Principles as a catalyst for change – the Flintshire experience

Flintshire County Council, lead authority for the Clwyd Pension Scheme, reports that the fund had anticipated and addressed a number of issues covered by the Principles prior to 2002. The issue of compliance with the Principles has led to a number of positive changes in the fund:

- The introduction of a business plan (three year plan updated annually).
- An independent advisor's report to the Panel on scheme governance.
- A widened Panel with representatives from two other unitary Councils and named substitutes for standing elected Members.
- Focused training for Panel members (with an annual report to the Panel outlining training undertaken). Newly elected Members on the Panel have to complete three half day investment training courses before they can vote at Panel meetings.
- More focused agendas for Panel meetings (clearly separating items for action

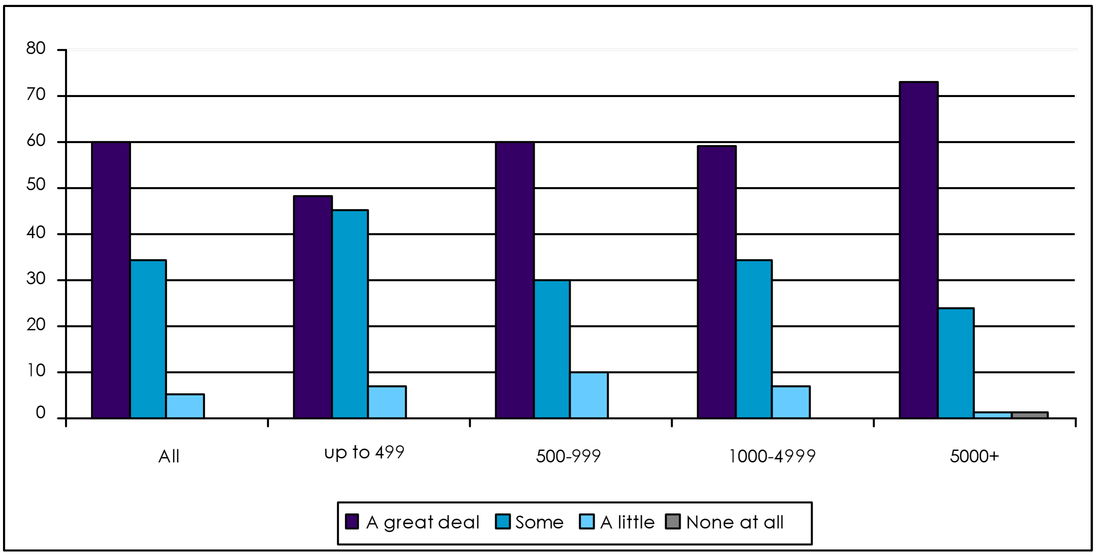
and items for information).

- An insistence on written (rather than oral reports) at Panel meetings.
- The inclusion on the agenda of all internal and external audit reports.
- To encourage local commitment – the introduction of arrangements whereby the unitary authorities take it in turn to host meetings and attend the Panel Meeting as observers.
- Additional reports to the Panel which include Transaction Cost Analysis, performance by AVC provider.
- Instigated a communications strategy and a dedicated web site.
- Included Governance Report on formal Panel agendas, including voting, media issues, LAPFF issues etc.

This behavioural change is not confined to local authority schemes. Helen Whitbread, Pensions Manager, Uniq plc summarised the position: "*Trustees have done a great deal to improve their effectiveness: working on TKU, training schemes and TPR's Trustee Toolkit; introducing Investment Sub-Committees and Business Plans; the increasing involvement of Independent Trustees with relevant knowledge. These have all been developments since Myners which have changed the way many Trustee Boards function and has made them more knowledgeable and professional in their approach.*"

Almost all the trustees surveyed (94%) by the NAPF said that a great deal or some progress had been made in ensuring their scheme was compliant with the Principles, with 60% citing a great deal of progress being made towards compliance.

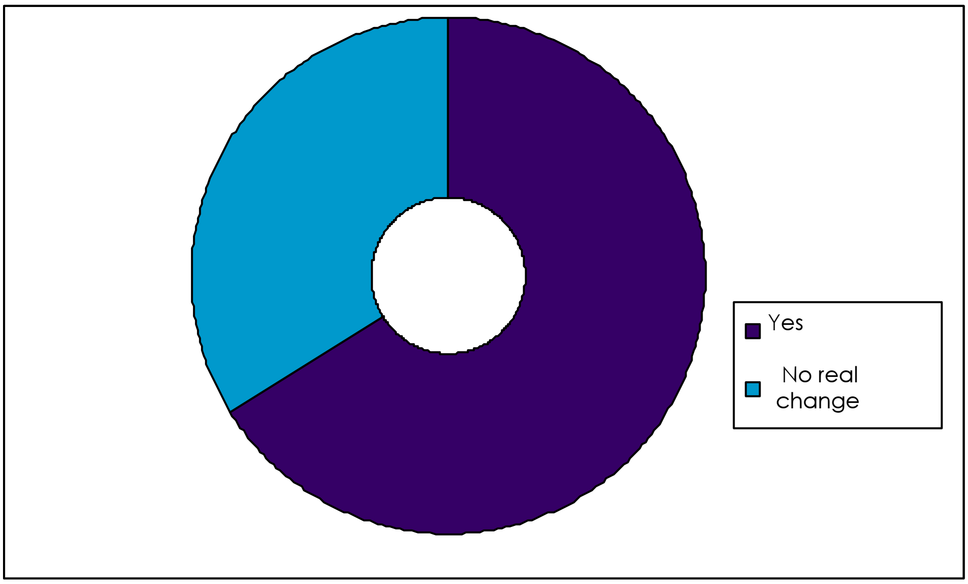
Fig 1: How much progress has your scheme made in complying with the Principles since 2001? (analysed by scheme membership numbers: % of schemes in each size category)



This progress has been the result of considerable effort on the part of trustees. Trustees nevertheless still feel that they have some way to go before they are fully compliant. While less than a fifth (18%) feel that they are fully compliant, only 3% believe that they still have a great deal of work to do.

Almost all trustees (96%) believe they have a good or reasonable understanding of the Principles and, of those trustees who were also trustees in 2001, over two-thirds (66%) now take their duties as trustees more seriously. Typically, trustees are now spending around 20 days a year on trustee business compared to 6-8 days prior to 2001.

Fig 2: Do you take your responsibilities as a trustee more seriously now than in 2001?



This positive view of behavioural change is supported by the Pensions Regulator's evidence to the 2007 Review in which it said: "*…in general the pensions industry … has dedicated resources and efforts to enhancing scheme governance frameworks since …2001*".

Progress Principle by Principle – a summary

The following section summarises progress against each of the Principles. A full analysis of progress for each of the Principles is set out in the Research Report that accompanies this Report.

Principle 1: Effective decision making

Respondents to the Discussion Paper are united in their view that this remains the key Principle and is at the heart of effective governance. Most respondents therefore felt the Principle remained relevant but did not believe that there was a need for the Principle to be strengthened.

There is not an objective measurement of the effectiveness of trustee decision making. However, like the 2001 and 2004 Reviews we have taken the processes in place to achieve compliance, focusing on trustees' levels of knowledge and understanding, as a proxy for effective decision making. Since the 2004 HM Treasury Review was undertaken the 2004 Pensions Act has legislated for trustees to have the knowledge "appropriate for the purposes of enabling the individual properly to exercise his functions as a trustee of any relevant scheme"[10]. The Pensions Regulator's Code of Practice on trustee knowledge and understanding (TKU), introduced in 2006, which supports this legal requirement, is based on Principle 1.

Taken as a measure of effective decision making, there appears to have been a step change in trustee effectiveness and their levels of trustee knowledge and understanding. Many of the weaknesses identified in the original 2001 Review, and which were identified as a continuing area of weakness by HM Treasury in 2004 have been addressed:

- 99% of trustees said they had a good or reasonable knowledge of pensions and investment issues;
- 65% said their knowledge had improved "considerably" since 2001; and
- 93% were either fairly or very confident they had the skills to fulfil their role.

This assessment is based on the self-reporting of the trustees in the quantitative survey and so may overstate the position. Nonetheless, there appears to have been a significant improvement in trustees' levels of awareness, a point borne out by The Pensions Regulator's second occupational governance survey that showed an increase in trustee training and a strong association between high levels of trustee training and scheme governance[11].

This progress has been in large measure a result of the investment in training. Almost half the trustees surveyed (49%) had attended a training course in the 12 months prior to the research being conducted, and three-quarters said that other members of their trust board had attended a training course. Typically, trustees spent 3-4 days on formal training over the past year. Training has been a mix of methods including formal training courses (such as those run by advisers), the TPR Trustee Toolkit, and the trustees' own study through research and reading.

Schemes have also made structural changes to their governance arrangements to enhance and professionalise their decision-making processes. Over half of schemes (and 83% of the largest schemes in our trustee survey) had investment sub-committees. A number of schemes report additional internal resources, whilst others have adopted governance structures more akin to corporate board structures.

10 Pension Act 2004, s 224
11 The Pensions Regulator 'Occupational pension scheme governance', July 2007

Box 4: Railways Pension Trustee Company ("The Trustee") Governance Structure

The Trustee is responsible for the £19 billion industry-wide, multi-employer Railways Pension Scheme looking after 350,000 members/pensioners. It is a corporate trustee with 16 Directors comprising employers (8), members (6), pensioners (2).

The Trustee regularly reviews its Committee Structure. An independent review was carried out by Watson Wyatt which focussed on efficient decision-making and responsiveness. The new structure, introduced from January 2007, allows the Trustee to concentrate on key reserved powers and general oversight with focussed and detailed consideration by Committees: Investment, Benefits and Funding, Executive, Audit and Case.

Membership of the Committees is between 4 and 8 and maximises the skills of Directors. There are external members of the Investment and Executive Committees. All the Committees have different chairs. The Trustee's subsidiaries, rpmi and Railpen Investments, have dedicated teams of professionals who advise the Trustee.

Continuing the emphasis on efficient decision-making and based on the principles of risk budgeting and decision sizes, the Trustee has delegated decisions up to £200 million to Railpen Investments. To aid their professional investment management service to the Trustee Railpen has recently applied for FSA Authorisation.

In recognition of their responsibilities, all Directors are offered remuneration with additional amounts for the Chair of the Trustee and Chairs of the Committees.

We place strong emphasis on Directors both meeting the TKU requirements and having knowledge of the RPS. Directors complete individual Training Skills Analyses and there is a comprehensive programme of external and internal training. The majority of Directors have successfully completed the Award in Pension Trusteeship or equivalent.

Principle 2: Clear objectives

Almost all respondents agree that progress in relation to Principle 2, which calls on trustees to set clear investment objectives for the fund that take into account the trustees' attitudes to risk and their willingness to accept underperformance. Overall, 95% of funds said they had set out in writing their collective beliefs to help guide their investment approach. 82% of schemes say the statement specifies the level of risk the trustees' are prepared to tolerate. Of those schemes that did not yet have such a statement (all with fewer than 5,000 members) 36% were working towards one.

A number of respondents say their scheme was already complying with the Principle prior to 2001. Others acknowledge progress has been made, but argue that this is as a result of market conditions rather than as a direct result of the Principles.

Examples of scheme practice include:

- Co-op: Investment objectives documented in the SIP and have regard to the scheme's liability and risk profile.
- Marks and Spencer: focused mandates for fund managers, periodic asset allocation reviews, use of LDI strategies to target the funding of the scheme's liabilities.
- USS: more realistic targets, investment philosophies being put in place and clear objectives for managers.

Investment managers' evidence to the Discussion Paper is unanimous in their agreement that trustees are now setting objectives relevant to the scheme and the adoption of scheme-specific risk-return targets.

Whilst respondents felt that the Principle remained relevant, there was a view that, as currently drafted, it does not take account of the need for trustees to take account of risk. Other respondents felt that the Principle has become embedded and that best practice has overtaken the Principle.

Principle 3: Asset allocation

Evidence gathered from responses to the Discussion Paper and in the trustee survey point to a high degree of compliance with Principle 3 which presses schemes to give due care and attention to ensure the scheme has an appropriate asset allocation.

Over three quarters (78%) of trustees surveyed said they were considering a wider range of asset classes than in 2001. This was the case for all the local authority schemes surveyed and 90% of schemes with 5,000 or more members. However, progress has not been even. Fund managers, investment consultants and pension funds all report slower progress amongst smaller schemes. Just 67% of the smallest schemes (those with fewer than 500 members) report having a wider asset allocation in 2007 than in 2001. In 2004 HM Treasury concluded that there had only been limited progress in improving the resources devoted to asset allocation. Three years on, it appears that trustees are giving more consideration to asset allocation, in particular the risks attached to the investments in determining asset allocation. Over half (53%) of trustees (and two-thirds of trustees of larger schemes) say that measuring and managing the risks in determining asset allocation is the primary driver, whilst for a further 37% it is one of the main reasons.

Rather than being driven by the Principles themselves, this progress has largely been driven by events: deficits; scheme specific funding; rising liabilities and the shift to liability driven investment. Of those funds reporting a wider asset allocation, only 2% of funds said this was in direct response to the Principles. By comparison, 62% said it was to spread or reduce risk, and 19% said it was part of a strategy to seek higher investment returns.

Whilst there was general support on the need for a continuing focus on asset allocation, there was also a view that the Principle as currently drafted was overly prescriptive. Moreover, it has not stood the test of time well as it does not give sufficient weight to scheme liabilities, the assessment and measurement of which have become increasingly important, not least in the context of the need for trustees to understand the strength of their sponsor covenant.

Principle 4: Expert advice

This Principle enjoined trustees to seek separate tenders for investment and actuarial services and that the fund should be prepared to pay sufficient fees to attract a wide range of advice.

Respondents to the Discussion Paper believed that actuarial services and investment advice are increasingly put out to separate tender, and this was the practice for the majority of the funds responding to the Discussion Paper. Excluding those who were not trustees at the start of the period over half (54%) said they had access to more sources of advice in 2007 than six years previously. The results are much the same across all scheme sizes and types with the exception of DC schemes (where only 40% of schemes were using more advisers) – a reflection of the need for different types of advice, for example, and their more recent arrival onto the pensions scene.

Particular concerns arose over the applicability of the need for small schemes to tender separately for investment and actuarial advice due to the costs involved of separate tendering exercises.

Respondents questioned the on-going relevance of this Principle. There was a view that, as currently drafted, the Principle was too prescriptive and that funds should be free to select their own advisers according to their circumstances (and that this should include buying bundled services where this was considered appropriate). It was therefore not surprising that there was very little support for the proposal based on, but going beyond, a recommendation in the Morris Review of the Actuarial Profession, that pension schemes should contract separately for strategic asset allocation and investment manager selection advice; many respondents felt that the close link between the asset allocation and investment manager selection processes meant that investment strategies benefited from the contracts being combined. The Morris Review's further recommendation that actuarial services should be re-tendered every six years, with reviews every three, was seen as excessively prescriptive and costly.

Principle 5: Explicit mandates

The results of HM Treasury's 2004 Review of the Principles concluded that schemes had not made sufficient progress in clarifying the mismatch in perceptions between trustees and fund managers over investment time horizons. Schemes are continuing to make progress in setting explicit mandates. Scheme respondents to the Review report that they are now setting explicit mandates, including around timescales. This is borne out by the responses to the trustee research.

Table 1: Explicit written mandates – subject covered (percentage of schemes by size)

	Benchmarks	Risk tolerances	Manager's approach	Timescales
All	65	57	56	53
>5,000 members	71	62	60	50
<5,000 members	63	55	46	54

On the important question of timescales, a number of respondents to the Review expressed the view that progress had not been as rapid as in other areas. A number of respondents commented on the short termist nature of mandates.

None of the schemes responding to the Discussion Paper said they terminated mandates prematurely due to underperformance alone. One private sector fund reports: "*Mandates are terminated where the Trustee no longer has confidence in the manager to meet the requirements of the mandate. Under-performance is evaluated in order to determine the causality*". The story is much the same in the public sector, with one local authority fund stating: "*… we have never terminated a mandate for underperformance alone. We believe in actively engaging to ascertain the reasons for underperformance and to determine if philosophy and process remain sound*".

There was general support for the importance of this Principle, though a recognition that it needs to be less prescriptive. It was noted that there was duplication of this Principle with Principle 7 (appropriate benchmarks).

Principle 6: Shareholder activism

Comments on this Principle which calls on trustees to take a more interventionist approach in regard to the companies in which they hold shares attracted a large number of responses. The generally held view was that behaviour had changed in the way envisaged by the Principle. It was, however, recognised that change was greatest amongst larger funds. This is, perhaps, not surprising as the assets of smaller schemes tend to be held in pooled funds.

Overall, two-thirds of trustees surveyed were familiar with the ISC Statement of Principles (SoP). The 2007 NAPF Engagement Survey shows that 80% of scheme managers in large schemes were familiar with the content of the ISC SoP[12]. It also shows that not only have engagement levels increased (in the UK and now in overseas markets in which UK funds hold shares) but that standards of corporate governance are perceived to have risen as a result. The ISC SoP is generally incorporated into managers' contracts by way of a side letter or in the scheme's SIP. This picture of progress is confirmed by investment managers and consultants, though again there is an acknowledgement that progress has been fastest amongst the largest funds.

Schemes provide the following as evidence of an increased level of shareholder engagement:

- ISC Principles are being increasingly built into mandates.
- Trustees have detailed their voting policy in their SIP and receive regular reports from investment managers on how votes are cast.
- Staff resource dedicated to responsible investment has increased.

Votes cast against investee companies could be taken as an indication of funds' growing engagement with companies. A third of the schemes surveyed for NAPF's research on the Myners Principles (and almost half – 48% – of schemes with 5,000 or more members and 55% of local authority schemes) had voted against the management of an investee company in the past two years.

Whilst the general view was one of progress, a minority felt that progress was lacking in a number of areas. For some, the level of engagement even amongst large schemes was felt to be wanting, although in at least one case this was based on the respondent's own interpretation of how the Principle should be implemented. For others, there was a view that the relationship between the managers and the owners (the trustees) was ill defined and that there was scope to improve the voting 'plumbing'. Others still felt that too little progress had been made in relation to disclosing how votes are cast. The Discussion Paper and trustee survey was completed before the ISC published its industry framework on voting disclosure. However, over a quarter (26%) of schemes already disclosed how votes were cast. This number rose to 31% for larger schemes.

There was a general view that while the Principle remained relevant for large schemes it was not appropriate for smaller funds. There was strong support for adopting the 2004 amendment, namely that the Principle should refer to the ISC SoP and not the US Department of Labor Interpretive Bulletin and for further industry guidance, for example on issues such as stock lending.

[12] *Pension Funds' Engagement with Companies, NAPF, August 2007, page 7*

Principle 7: Appropriate benchmarks

Evidence gathered suggests a high degree of compliance on Principle 7, which requires trustees to consider the use of appropriate benchmarks and the use of active versus passive management.

The view of consultants and investment managers is that scheme-specific benchmarks are now very much the norm, particularly amongst larger schemes for whom the Principle remains most appropriate. One asset manager summarises the views of respondents, stating: *"Our experience supports the assessment [in the Discussion Paper] for large schemes – we now have no clients whose assets are managed on a segregated basis that retain peer-group benchmarks – but not for smaller clients invested on a pooled basis where we manage c.130 schemes (worth c.£1 billion) where an industry benchmark continues to be used."*

The views in response to the Discussion Paper are borne out by the trustee research. Overall, 65% of schemes had moved away from industry average benchmark – take up of scheme-specific benchmarks was similar across all scheme types. Smaller schemes were less likely than larger schemes to have adopted tailored benchmarks – 41% of the smallest schemes in the survey (those with fewer than 500 members) were still using industry average benchmarks compared to just 23% of the largest schemes (those with 5,000+ members).

Where industry average benchmarks continue to be used, this appears to have been the result of active consideration by schemes. Larger schemes (those with more than 5,000 members) tended to cite the fact that "it was not worth the switch" (15% of schemes) and that "the industry average benchmark is more appropriate for us" (15% of schemes). Just over a quarter of small schemes (those with fewer than 500 members) said that the need for a scheme-specific benchmark had "not arisen", a view also held by 20% of larger schemes. A further 20% of small schemes said they "did not have the technical resources to set up a scheme-specific benchmark".

Whilst the Principle is seen as being relevant, it is also seen as in need of updating. It was also felt that there was some duplication with Principle 5 on explicit mandates.

Principle 8: Performance measurement

Progress on this Principle, which calls on trustees to assess their own performance and that of their investment managers and advisers, has been uneven.

Considerable progress has been made by trustees in measuring the performance of investment managers. Schemes responding to the Discussion Paper all report having processes in place to measure their asset managers, and in many instances these existed prior to 2001. This is supported by the trustee research which shows that 81% of schemes have conducted a formal performance measurement of their fund managers. The very smallest schemes (those with fewer than 500 members) were least likely to have adopted such processes, while 91% of the largest funds and all the local authority funds have conducted such reviews.

Progress has been less rapid in relation to the assessment of the performance of investment consultants. Overall, just over half (52%) of schemes undertook a formal assessment of their investment consultants – 58% for the largest schemes and 50% for the smallest schemes. There was a consistent view amongst pension schemes, investment consultants and fund managers that progress had been constrained by an absence of measurement tools that allow trustees to evaluate and compare consultants on a consistent basis. This view was supported by the trustee research where 51% gave as their main reasons for not formally assessing their consultants the difficulty in comparing consultants and the fact that there is no agreed 'best practice' methodology.

To help plug this gap, the NAPF is working with pension funds and investment consultants to develop methodologies that will help trustees assess, measure and compare investment consultants' performance. Work will comprise:

- a survey of pension funds' experience of consultants, which will establish a new benchmark by which to assess them;
- specifying the data which, as a minimum, should be provided by investment consultancies in order to make it easier for pension funds to compare the services and capabilities of each consultancy;
- a model Balanced Scorecard to promote dialogue and understanding between pension funds and their investment consultancies; and
- a set of voluntary Best Practice Principles for use by participating investment consultancies.

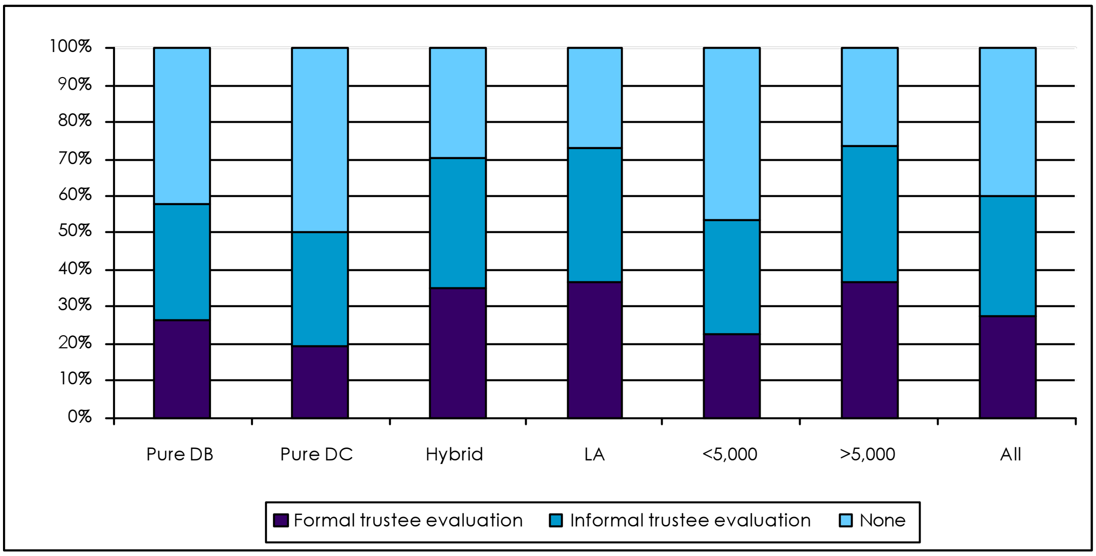
This work will be completed during 2008.

Whilst compliance has risen in relation to the measurement of investment managers and consultants, trustees have made significantly less progress in relation to putting in place processes, whether formal or informal, to assess their own performance.

A number of the pension funds responding to the survey, for example Barclays, the Electricity Supply Pension Scheme (ESPS), and Tyne and Wear pension fund, did undertake formal reviews of trustees' performance. However, it was clear that this was by no means common practice: overall, just 27% of funds had formal measures in place to assess their own performance and 37% had informal measures in place (see Figure 3, on page 29).

This is the area where the least progress has been made in applying the Principles. Further measures will be needed to provide trustees with the tools, support and encouragement to embed self-assessment in trustees' regular activities.

Fig 3: Trustee self-assessment by scheme size and type



Principles 9 and 10: Transparency and regular reporting

It was generally felt that schemes had secured a high degree of compliance with Principles 9 and 10. Examples of the steps schemes had taken to comply with the Principles included:

- Barclays: greater documentation of Myners compliance.
- M&S: Principles referenced in SIP and annual financial statements.
- SAUL: reports on compliance set out in the annual report and accounts.
- USS: detailed SIP published in its annual report and accounts and on its website, which also includes details of the fund's holdings and corporate governance activities.

This activity is supported by the results of the trustee survey which shows a high degree of member communication being undertaken by schemes. Members were communicated with at least once a year, with 42% of schemes communicating with members twice a year, and 22% once a quarter. Of those schemes that do not automatically send members key information from the SIP, 93% send it on request. It was generally acknowledged that this progress was as a result of legal developments requiring greater disclosure, rather than as a direct result of the Principles.

Whilst there was universal support for the principles of reporting and transparency, there was no great support for the continuing relevance of the Principles as they are currently drafted. Concerns were grouped around four main themes:

- **The Principles are out of date:** Much that is set out in the Principles has been overtaken by the Pensions Act 2004 and the need to disclose to members scheme funding levels.

- **The Principles are too prescriptive:** As drafted, the Principles do not give schemes the flexibility to communicate in a way that suits the scheme and its members. A high level Principle which then gave schemes flexibility on how it should be applied would be more effective.

- **Consolidation:** There is scope to consolidate and simplify the Principles by consolidating Principles 9 and 10.

- **Website:** A number of schemes surveyed did have dedicated websites – 38% of schemes overall and 55% each for local authority and large schemes. Despite this development, the need for all large schemes to have websites was questioned and was seen by some as being "overkill".

Independent Compliance Review

At HM Treasury's request, the NAPF also consulted on whether a proposal for a mandatory Independent Compliance Review (ICR) should be taken forward. The ICR would be a mandatory framework for schemes with assets over £250 million to assess and disclose to members progress on complying with the Principles.

Whilst there was general support for greater disclosure, there was almost no support for the proposed ICR amongst respondents to the discussion paper, whether from pension funds, asset managers, advisers or representative organisations. Only three of the respondents to the discussion paper supported the proposal for an ICR. Objections to HM Treasury's proposal fell into three broad categories.

1. It was felt that the costs of producing an ICR outweighed the benefits:
    - *"We do not see any added value over and above the approach already in place."* NGEG Group Trustees.
    - *"The use of an independent body to review a fund's compliance with the Principles is theoretically appealing, but the additional time and cost implications may outweigh the benefits."* Russell International Group.
    - *"[The ICR] is unnecessary for those schemes already compliant. For schemes who currently are not, many of which are smaller schemes, there is a risk that these changes, even if voluntary, might hasten the shift to contract-based defined contribution arrangements."* Investment management firm.

2. Respondents felt that HM Treasury's proposal was too prescriptive and inflexible, and did not reflect current best practice:
    - "*…The specifics of such a review, including but not to [its] nature, timing and scope should be determined by the trustees*". TPR.

- *"Good governance should be assessed against evolving best practice … Consequently an annual compliance exercise based on [the Myners Principles] … is not appropriate*". FTSE 100 pension fund.

3. Respondents also felt that the ICR had been overtaken by events and, in its current form, was no longer relevant:
   - *"Given that the majority of the provision of the principles are either now included in other regulation or have been superseded as best practice…an audit would introduce an additional layer of cost without providing any additional comfort to members*". Barclays Pension Scheme.

It was, however, recognised that there could be scope for further voluntary action on compliance and that this could be linked to the assessment of trustees' own performance. Proposals on how this could be achieved are set out in the final chapter.

4. Emerging issues

Summary:

- Progress has been strongest on TKU; asset allocation; appropriate benchmarks and transparency and reporting.
- The areas of **weakness identified by HM Treasury in 2004 have been largely addressed.**
- Trustees have been least responsive to assessing their own performance.
- Compliance is lower amongst smaller schemes, as might be expected given the resource constraints they face.
- Targeted help will need to be provided to ensure standards of governance and decision making continue to rise.

A continuing positive direction of travel…

The findings from the evidence-gathering exercise conducted by the NAPF review show that considerable progress has been made with compliance across all the Principles. It is clear that the Principles have become "accepted wisdom" and now form a core part of trustees' regular activities.

Progress has been particularly strong in the following areas:

- **Trustee knowledge and understanding:** On the core issue of effective decision making, there appears to have been significant progress. There has been a step change in trustees' knowledge and the effectiveness of their investment decision making. This is reflected in a high degree of confidence amongst trustees in tackling today's pension fund investment and governance issues. Trustees are spending more time than ever before on their duties. (Principle 1).

- **Asset Allocation and advice:** Schemes of all sizes are now investing in a wider pool of assets and are seeking more sources of advice to help them in their investment decision making. (Principles 3 and 4).

- **Appropriate benchmarks:** There has been a general move away from industry benchmarks towards scheme specific benchmarks. (Principle 7).

- **Transparency and reporting**: Schemes are more active in disclosing information to members. (Principles 9 and 10).

In 2004 HM Treasury noted that, whilst considerable progress had been made on some Principles, there were six areas where compliance was lagging. Three years on, these areas of weakness appear to have been largely addressed.

Table 2: Extent to which 2004 weaknesses have been addressed

2004	2007
Trustee boards do not have the necessary skills, expertise and resources to ensure effective decision-making.	Trustees have acquired higher levels of knowledge and understanding and consider themselves better trained. They consider themselves to be better equipped to undertake their functions and are actively undertaking training.
Continuing lack of clarity in the roles of trustees and their advisers.	Trustees are evaluating their investment advisers and managers more actively and using a wider pool of advisers and managers – a reflection of the fact that the investment environment for pension funds has become more complex since 2004.
Insufficient resources devoted to asset allocation.	Time spent on trustee duties has risen significantly since HM Treasury's 2004 review – from 6 to 8 days in 2001 to 20+ days in 2007. In light of the financial and regulatory environment, much of this time is now spent considering investment and funding issues.
Mismatch over time horizons	Progress has been positive, with over half of all funds now including timescales for evaluation in mandates. But there is further to go in applying this Principle.
Insufficient level of shareholder engagement	Behaviour has changed in the way envisaged by the Principle, mostly amongst large schemes.
Poor quality commentary on, and disclosure of, progress on compliance.	Levels of member communication have increased significantly. Information on compliance now frequently contained in the SIP and/or financial statements.

…but progress has not been even

Despite high overall levels of compliance, progress has not always been even:

- some Principles have been more fully complied with than others;

- some sectors have reached higher levels of compliance than others; and
- the Principles have been applied differently in different scheme types.

Trustee self-assessment

Whilst trustees have made significant progress in assessing the performance of their advisers, in particular investment managers, they remain reluctant to assess their own performance. As with company boards, it is important that trustees apply the same scrutiny to their own performance, individually and as a board, as they do to that of their external professionals.

Small schemes

In its 2004 Review, HM Treasury found much lower levels of compliance amongst smaller schemes compared to larger schemes. Based on the evidence gathered in this review, it remains the case that there is a clear correlation between scheme size and compliance with the Principles. Large schemes account for the majority of the assets in UK pension funds, with the very largest schemes (with 10,000 or more members) – 4% of schemes by number – accounting for 67.5% of scheme assets[13].

Whilst small schemes are likely to report similar levels of improvements in knowledge and understanding, and be as likely to be using more sources of expert advice, they are less likely to: report that they have a good knowledge and understanding of pensions; have an investment sub-committee; and consider a wider range of assets than in 2001. Overall, small schemes are less likely than large schemes to have made a great deal of progress in applying the Principles.

Table 3: compliance by scheme size

	Small <500 members	Large >5,000 members
Good knowledge of pensions and investments	42	69
Knowledge has improved considerably over last 6 years	59	58
I have attended training in last 12 months	47	45
Scheme has separate investment sub-committee	24	84
Fund now considers a wider range of assets than 2001	66	88
Extent trustees measure and manage characteristics of risk	42	66
Scheme has more sources of expert advice	49	48
Mandates include timescales for evaluation	51	50
ISC statement included managers' contracts directly	16	34
Scheme uses scheme-specific benchmarks	55	70
Scheme has formal performance measures for assessing trustees	19	37
Scheme has formal performance measures for assessing fund managers	69	91
Scheme has formal performance for assessing investment consultants	50	58
Scheme has made a great deal of progress in applying the Principles	48	73
Trustees very confident in having knowledge to fulfil role	31	45
Average length of time been a trustee	typically 3-4 years	typically 11-20 years

13 *The Purple Book: DB Pensions universe risk profile, PPF and TPR, 2006, pages 29 and 30, tables 4.2 and 4.3. DB schemes only; both percentages are in fact overstated as large schemes are over-represented in the TPR sample.*

These findings are not altogether surprising:

- Small schemes have fewer internal resources to devote to pensions matters – very often in smaller schemes, the senior staff member dealing with the pension scheme will often also be responsible for a range of other company responsibilities, e.g. HR and/or finance. And often they will be tackling these tasks single-handed.

- They have less access to expert advice than their larger counterparts and are less likely to have the resources to buy in specialist governance or investment advice.

- They are less likely than larger schemes to appoint professional, paid, independent trustees.

- Due to the value of assets under management, they are less likely to have access to the investment efficiencies that come with scale.

Nonetheless, there is a long tail of small trust-based occupational schemes (often DB) which account for a large number of individuals accruing benefits. The position of small schemes will need to be considered in taking forward the Principles.

Defined contribution schemes

One of the major changes to the pensions landscape over the past six years has been the rise of DC schemes, both trust-based, but especially contract-based. In 2001, just over 3 million people were members of workplace DC schemes. Today the number is closer to 4 million.

The Myners Review noted that while DC pensions currently account for a relatively small proportion of pension fund assets "there is no doubt that the future is likely to rest with defined contribution schemes" and that is it therefore crucial that the review considers them and the way in which investment decisions are made on behalf of members[14]. The Review identified three key features that distinguish DC from DB schemes:

- members bear the investment risk (although the Review hastened to add that this does not mean that the individual makes investment decisions);

- the scheme must be able to provide a valuation of each member's account at short notice; and

14 *HM Treasury 'Institutional Investment in the United Kingdom: a review' 2001, page 99, paragraph 6.8.*

- there is no pooling of members' risk.

Trustee involvement in DC raises many of the same issues as for DB schemes, in particular the trustees' level of investment expertise; the resources that they are able to bring to bear on their responsibilities; and the incentives that they create for fund managers through performance measurement. But it also raises a number of issues specific to DC, identified in the Myners Report as:

- the need for trustees to determine individuals', rather than the sponsor's, appetite for risk; and

- the pressures for an excessively conservative investment approach.

The Myners Review recommended that investment decisions taken on behalf of DC scheme members should accord with a set of principles slightly different to those for DB schemes, the main differences being that:

- where a scheme is offering a default option, trustees should ensure that an objective is set for the option, including expected risks and returns (an additional Principle – DC Principle 4); and

- when selecting investment options, trustees should take into account members' preferences and ensure that they offer a sufficient range of funds to satisfy the risk and return combinations reasonable for most members.

As with DB schemes, the 2001 Report placed considerable emphasis on member communications, but with the additional need to advise members, and potential members, of the different choices open to them.

Trustees of DC schemes have clearly taken steps to apply the Principles in the last few years, and in some areas (knowledge and understanding, attendance at training courses over the past year and confidence to fulfil their role) they report marginally more positive results than their DB counterparts.

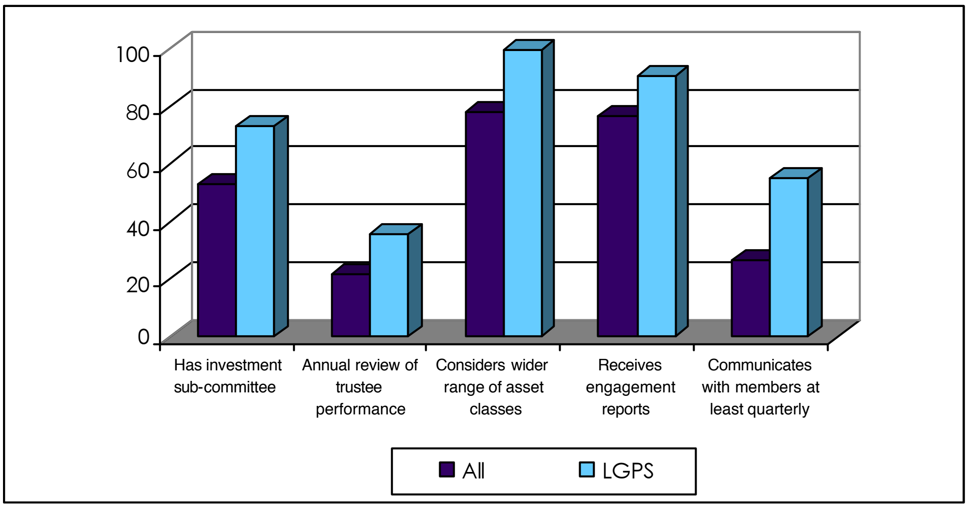
Participants to the Review recognised the importance of governance in a DC setting and identified a number of governance issues that were raised by the shift from DB to DC. These included the importance of the default fund, offering an appropriate range of fund choices, and member communication. Some went as far as to suggest that the focus of pension fund governance in future should be on DC schemes whilst others felt that contract-based DC would always fall outside the scope of the Principles and that the governance issues were effectively taken care of through the FSA's 'Treating Customers Fairly' rules.

Local authority schemes

The Local Government Pension Scheme (LGPS) is governed by a national statutory framework and administered locally by 89 separate authorities. These funds are amongst the largest in the UK: 37 funds have assets in excess of £1 billion. Compliance with the Principles is a matter for each of the 89 administering authorities in England and Wales to measure and publish under a regulatory framework introduced by the scheme's regulators, CLG, in 2002. Authorities are also required to state their reasons for any non-compliance. These arrangements have given the Principles a higher profile than might be the case for some private sector schemes.

Overall, compliance with the Principles amongst local authority schemes was high, and in a number of areas they were ahead of their private sector counterparts in terms of compliance (see figure 4 below). And as the example from Flintshire (box 3) shows, the Principles have been a catalyst for change in how schemes structure themselves and arrange their governance functions. Attendees at the roundtable organised by NAPF for LGPS officers and elected members placed considerable emphasis on transparency and regular reporting, where they felt that local government schemes had made considerable progress – indeed, transparency and regular reporting could be seen as reducing the burden on officers, who could refer enquiries to reports that were already available and easily accessed.

Fig 4: How Local Government Pension Schemes compare with other schemes



The elected members who take on the governance function in the local government scheme tend to be "trustees" for shorter periods than trustees in the private sector. This was an issue that was discussed at length at the roundtable the NAPF hosted for local authority elected members and officers in July. A number of participants reported that the May local elections had resulted in a significant change in the composition of their 'trust' boards and with it the collective knowledge and understanding of the Board. In the local authority setting this is addressed by the fact that full time, professionally qualified officers have a very prominent role in underpinning the skills and knowledge expected of members sitting on LGPS committees and of ensuring they have access to an effective and robust training framework. The Local Government Employers (LGE) provides an extensive training programme for members involved in LGPS trusteeship, and more recently the Chartered Institute of Public Finance and Accountancy (CIPFA) has included in its work programme the publication of a comprehensive guide to the skills and knowledge expected of officers and others supporting the work of committees. In the final analysis, the statutory duties for managing and investing local authority pension funds rests with the designated administering authority as required by the relevant legislation.

Principles overtaken by events

In addition to addressing specific areas of under-compliance, the evidence Review also points to a need to update the Principles: some have not stood the test of time, whilst others have been incorporated into legislation or regulation, in some cases as a result of the Myners Review's recommendations.

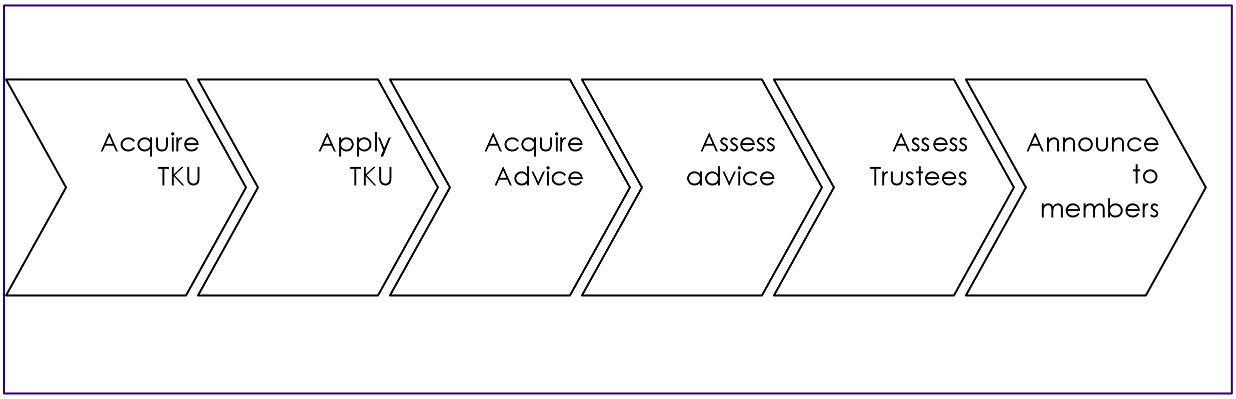
- The 2004 Pensions Act has placed a legal duty on trustees to ensure that, within six months of being appointed, they have the appropriate knowledge and understanding to fulfil their duties.

- The Pensions Regulator's Codes of Practice have incorporated a number of facets of the Principles.

- The FSA now has rules relating to the unbundling of soft commissions that came into force in 2006.

In 2001, HM Treasury was concerned to ensure the efficiency of the investment chain. Six years on, the emphasis has moved to the *trustee* decision-making chain and good governance.

Fig 5: Effective trustee decision making chain



Given these developments, and parallel changes to the regulatory environment within which occupational pensions operate, the Principles can no longer claim to be best practice. As such, they will need to be reviewed to ensure they remain relevant and continue to drive forward trustee competence and effective investment decision-making. And if the Principles are to continue to have an impact and improve this trustee decision making chain, trustees will need to be supplied with the right tools, within an appropriate framework of comply or explain.

The next chapter sets out recommendations for developing the Principles to:

- address current under-compliance;
- refresh the Principles for today's pensions environment; and
- ensure on-going improvements in effective investment decision-making.

NAPF Securing the future of pensions

5. The future – taking the Principles forward

Summary:

Recommendation 1: Voluntarism should remain at the heart of the Principles, reinforced by a strengthened 'comply or explain' approach to reporting. The current voluntary regime is working well and has secured a high level of compliance. There is scope to adopt a strengthened 'comply or explain' framework in relation to trustees' disclosure of compliance with the Principles.

Recommendation 2: The current Principles should be replaced with fewer, higher-level, Principles for today's pensions environment. The current Principles should be slimmed down to six high level Principles that are relevant to the challenges trustees face today.

Recommendation 3: High level Principles should be supplemented by supporting guidance and toolkits to give trustees practical support. The slimmed down Principles should be supported by practical guidance for schemes and trustees. The industry has a leading role in producing and facilitating this guidance.

Recommendation 4: New approaches are needed to help smaller schemes comply with the Principles. There should be further work and consultation on how small schemes can best implement the Principles, including the options available to introduce scale economies to small schemes.

Recommendation 5: TPR should work with pension schemes, trustees and providers to take forward its proposals in relation to the governance of DC schemes. The rise of DC schemes presents new governance challenges which TPR should address. Principles for DC schemes should also be refreshed to ensure they are relevant to today's environment.

Recommendation 6: The Principles should be co-owned by TPR and the Pensions Industry. Ownership of the Principles should pass from HM Treasury. To ensure both effective industry ownership and a joined-up regulatory framework, the Principles should be jointly owned by TPR and the pensions industry.

Recommendation 7: Trustees should periodically undertake formal assessments of their own performance and that of the Board. Trustees of schemes with assets in excess of £250 million should undertake periodic reviews of their own performance and report on it to members in the annual report and accounts.

Recommendation 8: A further, targeted review should take place in three years. The review should focus specifically on those areas of under-compliance identified in this review as well as the continuing relevance of the Principles.

Recommendation 1: Voluntarism should remain at the heart of the Principles, reinforced by a 'comply or explain' approach to reporting.

The evidence gathered in the course of this Review demonstrates that, overall, schemes have responded well to the voluntary 'comply or explain' approach of the Principles. Implementation of the Principles is high and progress since the Principles were first published has been positive: standards of trusteeship, pension fund governance and investment decision making are on the rise.

Participants in this Review recognised that it is good practice for schemes to demonstrate and disclose to members that high standards of governance and investment decision making are being applied. However, responses to the Review were generally unfavourable to an inflexible, mandatory, Independent Compliance Review reporting framework which it was felt could diminish the quality of reporting and engagement with the Principles and was inconsistent with the Government's desire to ease the burden of regulation on Britain's workplace pensions.

To encourage greater disclosure, there is scope to adopt a strengthened 'comply or explain' approach in relation to trustees' disclosure of their compliance with the Principles. Trustees would be required to report to members on how they have applied the Principles. The form and the content would not be prescribed, the intention being that trustees should have a free hand to explain their governance policies.

This approach to disclosure is embedded in the Financial Reporting Council's Combined Code, which is generally recognised as having worked well in driving up governance standards within the UK's listed companies.

The combination of high level Principles (Recommendation 2), combined with secondary level, supporting guidance (Recommendation 3) that would give trustees the tools to help them achieve compliance and some indicators of when compliance would be achieved will be a valuable framework for reporting on compliance to members.

Targeted solutions that stop short of compulsion are proposed for those Principles and sectors where progress has not been as high as might be wished.

Action:

- Adoption of voluntary reporting on compliance along the lines of the Combined Code model.
- Supportive guidance and tools/practical support to be produced by the pensions industry and/or The Pensions Regulator.

Recommendation 2: The current Principles should be replaced with fewer, higher-level, Principles for today's pensions environment

The environment within which occupational pension schemes and trustees operate today – so radically altered from that which existed when Paul Myners undertook his original investigation, and HM Treasury assessed performance in 2004 – casts the Principles in a very different light:

- A number of the Principles have been superseded by primary legislation or are covered in other ways by regulators. The most obvious example is the requirement in the 2004 Pensions Act for trustees to have knowledge and understanding of the law relating to pensions and pensions trusts; the Principles relating to the funding of occupational pensions; and the Principles relating to the investment of the scheme's assets. This is supported by the Pensions Regulator's Code No 7 on Trustee Knowledge and Understanding and its on-line trustee toolkit. Financial Services Authority rules on soft commissions came into force in 2006.

- A number of issues of key importance to trustees today are not adequately covered by the Principles – a reflection of the times in which they were written. Most importantly these include:

  - **Risk:** Trustees must now take account of the risks attaching to their scheme. In particular, they must now take account of the strength of the scheme sponsor covenant and the risk of sponsor default.

  - **Liabilities:** The Principles focus almost exclusively on one side of the trustees' balance sheet – assets. They take little direct account of liabilities, which now stand at £612 billion for FTSE 350 companies on a buy-out basis[15]. This is now pre-occupying trustees in a significant way, not least due to the impact that rising longevity is having on scheme liabilities. In 2005-6 alone, life expectancy improvements added an additional £20 billion to schemes' liabilities.

Furthermore, many respondents felt there were a number of areas where the Principles no longer represented best practice:

- A number of the Principles were insufficiently high level and fell more into the category of 'guidance' than 'principle'. Principle 3 on asset allocation and Principle 5 on explicit mandates, for example, cover issues of implementation rather than high level principle. The reference in Principle 1 on the payment of trustees would be another example.

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- Compliance with a number of the Principles is now at such a high level, and its existence so widely accepted, that the purpose of the principle has been accepted into normal scheme practice. The assessment of investment managers' performance (Principle 8) would fall into this category.

- There is some scope to consolidate the Principles to provide a sharper focus for trustees and their advisers. For example, Principle 7 (appropriate benchmarks) could be combined with Principle 2 requiring trustees to set clear objectives. Likewise, Principles 9 (transparency) and 10 (regular reporting) would have more impact if consolidated.

Whilst the continuing need for a set of voluntary Principles was accepted by all, there was no real appetite for simply incorporating wholesale the amendments proposed by HM Treasury in 2004 (as amended via the subsequent consultation exercise). Instead, there was considerable support for a more radical approach that would create a shorter, higher-level set of Principles, relevant to today's pensions environment. These Principles would be supported by guidance and toolkits offering trustees practical support on governance and investment issues. (See recommendation 3.) Box 5 sets out a suggested revised set of Principles. These Principles cover the same ground as the 2001 Principles, but in a way that is genuinely principles based, giving trustees scope on implementation, and are relevant for today's circumstances.

Box 5: Principles for Pension Scheme Governance

1. **Effective decision making**
   Decisions should only be taken by persons or organisations with the skills, information, advice and resources necessary to take them effectively and monitor their implementation. Decision makers must have sufficient expertise to be able to evaluate critically the advice they receive.

2. **Clear objectives**
   Trustees should set out an overall investment objective/s for the fund that takes account of the scheme's liabilities, the strength of the sponsor covenant as well as the attitude to risk of both the trustees and the scheme sponsor.

3. **Risk and liabilities**
   In setting their investment strategy, trustees should take account of the risks and form and structure of the liabilities faced by the scheme. These include the strength of the sponsor covenant, including the risk of sponsor default and longevity risk.

4. **Performance assessment**
   Trustees should arrange for the formal measurement of the performance of the

fund, its managers and advisers. Trustees should also periodically make a formal assessment of their own effectiveness as a body and report on this to scheme members in the annual report and accounts.

5. **Responsible ownership**
   Trustees should adopt or ensure that their investment managers adopt the Institutional Shareholders' Committee Statement of Principles on the responsibilities of institutional shareholders and agents. A statement of the scheme's policy on responsible ownership should be included in the Statement of Investment Principles. Trustees should report periodically to members on the discharge of such responsibilities.

6. **Transparency and reporting**
   Trustees should act in a transparent manner, communicating with scheme members on issues relating to their management of the investments, including performance against stated objectives. Communication with members should be provided periodically in the form the trustees consider most appropriate.

   Trustees should also explain to members why they have chosen to depart from any of the above Principles.

Action:
- There should be a period of consultation on the proposed revised Principles.
- Adoption and promulgation.

Recommendation 3: High level Principles should be supplemented by supporting guidance and toolkits to give trustees practical support.

The six high level Principles should be supplemented by support for trustees:

- **Supporting guidance** setting out best practice, industry standards and some of the measures by which compliance might be measured. Guidance would be just that – trustees would not be expected to report on compliance with it and it would not form part of the 'comply or explain' reporting proposed at Recommendation 1.

- **Tools** to give trustees the practical help they need to ensure governance standards continue to rise. These could include, for example, toolkits to help trustees assess their own performance.

Annex B sets out a framework showing the interaction of main Principles, supporting guidance and the types of practical tools trustees may find helpful in securing compliance.

Some of the help and information trustees require is already available. Much of it is helpfully produced by TPR and incorporated in its Codes of Practice. Other trustee capacity-building is facilitated by the pensions industry (for example the NAPF's *Made Simple* series, the Trustee Learning Zone held annually at the NAPF Investment Conference and trustee training courses, PMI trustee accreditation). However, this Review demonstrates that in some other areas – trustee self-assessment, measuring consultants' performance, and measuring the strength of the sponsor covenant, for example – there is a lack of support material and guidance.

In its 2004 review, HM Treasury said the pensions industry should have greater ownership of the Principles. This view was generally accepted by the industry and the NAPF in particular. There would seem to be a very clear role for the pensions 'industry' to have an active role in producing and delivering guidance to schemes. It is right that the industry leads the drive to improved standards through its own advice and guidance to its peer group. This approach is likely to be far more effective than a top-down approach.

To push forward progress in this area, it is recommended that a 'gap analysis' of the support materials available (particularly those from independent sources) is undertaken. This initiative would need to involve a number of parties, including the Pensions Regulator. The NAPF is willing to lead this work which should aim to report by the end of 2008.

Using the results from the gap analysis, a package of toolkits should be developed. In order to ensure wide acceptance and take up of the support materials, it is recommended that these should be joint industry/TPR initiatives. The support materials will need to be supported by a programme to encourage take up.

Action:

- Discussions with relevant parties on supporting guidance and matrix.
- NAPF to undertake a 'gap analysis' of available trustee support materials and report by the end of 2008.
- A package of joint industry-TPR 'toolkits' should be produced to provide trustees with practical support.

Recommendation 4: New approaches are needed to help smaller schemes comply with the Principles.

The 2007 Review has identified that progress in applying the Principles has been less rapid amongst smaller schemes than larger schemes.

Whilst members of smaller schemes need good governance and effective investment decision making, simply continuing to expect smaller schemes to apply the Principles

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in the same way and with the same emphasis as they apply to larger schemes is unrealistic. Small schemes face more significant constraints in terms of both internal resource and access to expert advice than their larger counterparts, and they generally cannot access the investment efficiencies that come with scale. Moreover, given that the assets of small schemes tend to be invested via pooled funds, the applicability of some of the Principles to small schemes is limited.

In considering how next to develop the Principles, consideration will need to be given not only to the appropriateness of the Principles to small schemes but also the best mechanisms to encourage the application of high standards of governance by small schemes.

A number of approaches could be adopted which sit along a spectrum:

- **Tailored Principles for smaller schemes:** This approach could be seen as undermining the concept of high level Principles that remain relevant for different circumstances and changing conditions. However, we believe that the Principles we propose should be appropriate for all schemes, although how they are implemented will necessarily vary according to the particular circumstances of the scheme. Size will inevitably be a main determinant of how the Principles are implemented.

- **Consolidation:** Encouragement could be given to small schemes to consolidate and become larger schemes. In a DC setting, this would be relatively easy to achieve as there is no risk of cross subsidisation between participating employers. In a DB setting, it is less straightforward. However, many of the barriers to setting up a multi-employer scheme have fallen away following the A-Day tax reforms introduced by the Finance Act 2004. In its purest form, both benefits and liabilities could be consolidated. However, this could give rise to difficulties – with one employer facing the possibility of becoming responsible for the liabilities of another over which it has no control. A simpler approach could be to consolidate the assets and governance, leaving the liabilities with each scheme sponsor.

- **Run off:** Small schemes in run off could be overseen by The Pensions Regulator.

- **Buy-out:** The Pension Regulator's data points to a strong correlation between scheme size and the likelihood of that scheme still being open to new accruals: the larger the scheme, the more likely it is still to be open. The arrival of new buy-out companies could present small schemes, many of which are now closed, with access to scale economies in both investment and governance terms.

The Government has recognised the benefits of scale in its creation of the Personal Accounts scheme which will run as a large multi-employer arrangement.

Action:

- Consult with interested parties on how small schemes can best implement the new Principles.
- NAPF to undertake research on consolidation of small schemes, with a report back by the end of 2008.

Recommendation 5: TPR should work with pension schemes, trustees and providers to take forward its proposals in relation to the governance of DC schemes.

Concerns about DC governance have already been taken up by The Pensions Regulator which published, in April 2007, a discussion paper on the Regulation of Work-based Pension Schemes. It identified a number of governance risks to DC schemes and suggested, within a voluntary framework that did not go beyond the steps schemes are currently required to take, some best practice measures.

Just as the Principles need updating for DB schemes to take account of developments since 2001, the DC Principles also need to be refreshed to ensure they take account of the developments in DC provision and that they are principles based.

In addition, The Pensions Regulator plans to provide guidance for employers wishing to establish, on a voluntary basis, management committees that could provide a governance overlay for contract-based DC arrangements. The Regulator should continue with its plans to work with the industry in providing guidance for employers wanting to establish management committees.

Action:

- TPR to continue with its work in relation to guidance on setting up voluntary management committees.
- Refreshed set of Principles for DC schemes to be considered and promoted.

Recommendation 6: The Principles should be co-owned by TPR and the pensions industry

Since the Principles were first published in 2001, they have been effectively 'owned' by HM Treasury. However, since that time, there have been two significant changes that bring in to question HM Treasury's continued ownership of the Principles.

First, the regulatory landscape has altered radically. When the Principles were first published, pensions were regulated by Opra – a relatively new, but passive, regulator with limited powers and an even more limited remit. It did not, for example, have powers to require trustees to seek the knowledge or expertise necessary for the discharge of their duties. Since then, Opra has been replaced by The Pensions Regulator (TPR), a pro-active risk-based regulator with an explicit objective to ensure that trustees have the appropriate knowledge and understanding, and by statutory duties and Codes of Practice that take their lead from the Principles. TPR has become the arbiter of good governance and has recently turned its attention to the governance of DC schemes.

In light of TPR's role in this area, the case for HM Treasury's continued ownership is diminished.

However, the Government has also made it clear that it wants the pensions industry to have greater ownership of the Principles. In his introduction to the NAPF Discussion Paper, the then Economic Secretary to the Treasury said: *"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…"*

There has been general acceptance that an approach which has the buy-in of the pensions industry is more likely to yield results than a top-down approach.

To ensure maximum industry engagement and a joined up regulatory approach, we recommend that TPR and the pensions industry co-own the new, slimmed down Principles. There are a number of possible approaches. But one simple approach would be for the industry, led by the NAPF, to own a set of Principles that are endorsed by TPR and supported by joint industry/ TPR guidance. The NAPF would be happy to co-ordinate the industry's involvement.

Action:

- Ownership to move from HM Treasury to being co-owned by TPR and the pensions industry.
- Consult with TPR and the pensions industry on arrangements for joint industry/TPR ownership.

Recommendation 7: Trustees should periodically undertake formal assessments of their own performance and that of the Board.

As the analysis in this Review has shown, the area on which trustees have made the least progress is in assessing their own performance – whether individually or collectively as a board. Just 27% of trust boards have formal measures in place to assess the Board's performance and just 32% have informal measures in place. Performance measurement is particularly weak amongst small schemes and DC schemes (19% each having formal review mechanisms in place).

Performance measurement is now commonplace for investment managers: it allows trustees to assess how the manager is performing against the mandate, the service provided to the trustees and scheme members, and the quality of the manager's relationship with the trustees. In the corporate world, board performance assessment is also becoming more commonplace and the Combined Code sets out a framework for what Board evaluation should seek to achieve and how it should be disclosed to shareholders. It is right that performance measurement of trustees should also be applied to a far greater extent than has been the case to date. Without such assessments, trustees will not be able to tell that they are performing to a high standard (and applying and complying with other of the Principles). More importantly neither will scheme members.

The form of the self-assessment should not be prescribed. This should be for the trustees to decide in light of their own circumstances. Larger DB schemes, for example, might wish to take a different approach to smaller DC schemes and larger trust boards may take different approaches to smaller trust boards. However, (as in the case of the Combined Code) the evaluation should aim to show whether each trustee continues to contribute effectively and demonstrate commitment to the role (including the commitment of time for Board, committee and other roles). The Chairman should act on the results of the performance evaluation by recognising the strengths and addressing the weaknesses of the Board, for example through training or in the recruitment of trustees with particular areas of expertise. In extremis, this could also include the removal of a trustee.

Trustees should report on their own effectiveness to scheme members in the scheme's annual report and accounts. The form of the disclosure should also, however, not be prescribed. This will also be a matter for the tustees to determine in light of the scheme's circumstances.

It is recognised that, in order to encourage trustees to put in place formal self-assessment, trustees are likely to need some assistance. There are a number of tools already available to help trustees assess their performance, individually and as a Board. The assessment and availability of such tools should be considered in the NAPF's gap analysis (Recommendation 3). But it is likely that there may be scope to develop further tools so that self-assessment is built into the fabric of trustee activities (for example, by building self-assessment into formal training courses).

Action:

- Production of guidance and support for trustees to assist them in assessing their performance. Role for joint TPR/industry initiatives.

Recommendation 8: A further, targeted, review should be undertaken in 3 years

To ensure progress continues in relation to governance standards and effective investment decision-making, a further review of progress should be undertaken in three years' time. Given the progress that has been made and the Regulator's on-going role in this area, the 2010 review should focus specifically on trustee self-assessment.

The NAPF would be pleased to undertake such a review.

Action:

- Further, targeted review in 3 years' time.

Annex A
List of respondents to the Discussion Paper

1. Abbey National plc Amalgamated Pension Fund
2. Charles Amos, Esq.
3. Association of British Insurers
4. Association of Consulting Actuaries
5. The Association of Investment Companies
6. Association of Pension Lawyers
7. BAE Systems Pension Funds Investment Management
8. Baillie Gifford & Co
9. Barclays Pensions
10. British Airways Pensions
11. The Co-operative Group Pensions Department
12. Electricity Supply Pension Scheme
13. FairPensions
14. HSBC Actuaries and Consultants
15. Hymans Robertson
16. Insight Investment
17. Investment Management Association
18. The Investor Relations Society
19. Brian Johnson, Esq.
20. Jupiter Asset Management
21. Legal & General Investment Management
22. Geoff Lindey, Esq.
23. Marks and Spencer Pension Scheme
24. MNOPF Trustees
25. National Grid Electricity Group of the Electricity Supply Pension Scheme
26. National Grid UK Pension Scheme Trustee
27. Northumberland County Council
28. Nottinghamshire County Council
29. Pensions & Investment Research Consultants (PIRC)
30. The Pensions Management Institute
31. Pension Protection Fund
32. The Pensions Regulator
33. PricewaterhouseCoopers
34. Railways Pension Trustee Company
35. Russell Investment Group
36. Derek Scott, Esq.
37. SEI Investments
38. Shell Pensions Management Services
39. The Society of Pension Consultants
40. Standard Life Investments
41. Superannuation Arrangements of the University of London (SAUL)
42. Syngenta
43. Tyne and Wear Pension Fund
44. UK Social Investment Forum
45. Universities Superannuation Scheme (USS)
46. Watson Wyatt
47. West Sussex County Council

Written details of their pension scheme arrangements were provided by Bedfordshire County Council, BP Pension Trustees, Flintshire County Council and West Yorkshire Pension Fund.

Annex B

2007 Principles Matrix

The following governance and investment decision-making framework operates on a voluntary 'comply or explain' basis. It is intended to show the interaction of the main Principles, supporting guidance and the types of practical tools trustees might find helpful in securing compliance. The points set out under tools are not intended to be exhaustive, and may be augmented following consultation and as new tools are developed.

Principle	Supporting Guidance	Tools
The high level Principles would be the accepted code of best practice throughout the industry in governance and investment decision-making.	***Supporting guidance sets out best practice, industry standards and some of the measures for the application of the Principles. It is not expected that trustees would report on compliance with the guidance. Rather they would use the guidance to judge whether compliance had been achieved.***	***Tools provide practical help and support to trustees and their advisers to enable them to apply the Principles and ensure that standards of governance and investment decision-making continue to rise.***
Principle 1: Effective decision making Decisions should only be taken by persons or organisations with the skills, information, advice and resources necessary to take them effectively and monitor their	• Trustees should ensure they have sufficient internal resource and access to external resources. • It is good practice for trust boards to have investment sub-committees to	• TPR Trustee Toolkit and other training material. • Publication of best practice guidance/ templates etc – eg in relation to business plans, scheme structures etc.

implementation. Decision makers must have sufficient expertise to be able to evaluate critically the advice they receive. *[Current Principles 1 and 4]*	provide the appropriate focus and skills on investment decision-making. • Trustees should draw up a forward-looking business plan and evaluate its progress. • It is good practice for trustees to be paid.	• Publication of industry-average lay-trustee remuneration.
Principle 2: Clear objectives Trustees should set an overall investment objective/s for the fund that takes account of the scheme's liabilities, the strength of the sponsor covenant as well as the attitude to risk of both the trustees and the sponsor. *[Current Principles 2, 5 and 7]*	• It is best practice for trustees to adopt scheme-specific benchmarks and objectives, unless there is a clear reason why this is not appropriate. • Trustees should provide their fund managers with clear written mandates which include clear time horizons for performance measurement and evaluation.	• TPR guide on covenant assessment. • Actuarial valuation and advice. • Risk budgets.
Principle 3: Risks and liabilities In setting their investment strategy, trustees should take account of the risks and form and structure of the liabilities faced by the scheme. These include the strength of the sponsor covenant, including the risk of sponsor default and longevity risk.	• Trustees should have a clear policy on their willingness to accept underperformance due to market conditions. • Trustees will want to analyse interest rates, inflation and longevity projections and receive advice on how these impact on their scheme and its liabilities.	• TPR guide on working with the employer and on scheme investments. • Code of Practice N° 3 on Funding Defined Benefits. • Actuarial valuation and advice. • Risk budgets.

[Updates Principle 3]	• In setting the investment strategy, the trustees will wish to ensure it is consistent with the scheme sponsor's objectives and ability to pay.	
Principle 4: Performance assessment Trustees should arrange for the formal measurement of the performance of the fund, its managers and advisers. Trustees should also periodically make a formal assessment of their own effectiveness as a body and report on this to scheme members in the annual report and accounts. *[Current Principle 8]*	• Trustees should have in place a formal policy and process for assessing the performance of individual trustees. • Individual performance should show whether each trustee continues to contribute effectively and demonstrate commitment to the role (for example measured by attendance at meetings). • The chairman should act on the results of the performance evaluation by recognising the strengths and weaknesses of the Board. • Trustees should state in their annual report and accounts how the performance evaluation has been conducted.	• Trustee 'Key Performance Indicators', eg covering issues such as attendance at trustee meetings, training log, annual review meetings with the trustee chair etc. • Investment management reports • Assessing consultants' performance 'toolkit', eg model Balanced Scorecard etc.
Principle 5: Responsible ownership Trustees should adopt, or ensure their investment managers adopt, the Institutional Shareholders' Committee Statement of Principles on the responsibilities of shareholders and agents. A statement of the scheme's policy on responsible ownership	• It is good practice to disclose to members of the scheme the trustees' attitude to and policies regarding responsible ownership responsible ownership in the annual report and accounts or in the Statement of Investment Principles.	• ISC Statement of Principles • Statement of Investment Principles

should be included in the Statement of Investment Principles. Trustees should report periodically to members on the discharge of such responsibilities. *[Current Principle 6]*	• Trustees should ensure that managers have an explicit strategy, setting out the circumstances in which they will intervene in a company. • It is good practice for trustees to ensure their investment consultants to adopt the ISC's Statement of Practice relating to consultants.	
Principle 6: Transparency and reporting Trustees should act in a transparent manner, communicating with scheme members on issues relating to their management of investments, including performance against stated objectives. Communication with members should be provided periodically in the form trustees consider most appropriate. *[Current Principles 9 and 10]*	• Reporting should: o Ensure that the scheme operates transparently and enhance the accountability of trustees to scheme members; and o Ensure that reporting against best practice provides a basis for the continuing improvement of governance standards. •	• Statement of Investment Principles • Websites/ helplines (for larger schemes) • Annual report and accounts

Annex C

Recommendations and Actions

Recommendation	Action
Retain voluntarism	Extend comply or explain in relation to disclosure
Fewer, higher level, Principles	Consultation on new Principles
Supporting guidance/ tools	Promote guidance Gap analysis – end 2008 TPR/ industry to develop tools
Help for smaller schemes	Investigation and consultation on ways to support smaller schemes
Governance for DC schemes	TPR action plan
NAPF/TPR co-ownership of Principles	Transfer ownership Promote Principles
Trustee self-assessment	Develop toolkit (NAPF/TPR etc) Active promotion of toolkit and reporting/ review
Further review in 3 years' time	NAPF willing to undertake review

Annex D
List of boxes, figures and tables

Boxes

Figures

Tables

NAPF

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