NAPF
Securing the future of pensions

NAPF Response to the Walker Review

Introduction

The National Association of Pension Funds, which represents the interests of UK occupational pension funds with assets in excess of £700bn, has taken a close interest in the issues arising from the banking crisis, which has affected its members in many different ways. It therefore welcomes the opportunity to comment on the review carried out by Sir David Walker. In addition to our specific comments which are set out below, we make a more general point.

Firstly, all of the changes and innovations proposed should be designed with the object of changing the behaviour of companies and investors so that they focus more on the creation of value over the longer term. This is a complex issue and there will be many views on definition as well as the route to achieving that goal, but pension funds and their members have not been well served by the concentration in the financial sector on short term gains which have been made at the obvious expense of the longer term and at significant cost to shareholders. The main elements of the structure needed to effect the changes we seek are set out in your consultation document. These are, in short:

- better informed boards which can demonstrate to shareholders (and others) that they have the skills to review strategy critically and have the ability to assess their own performance;
- shareholders who have sufficient quality information to hold boards to account and are prepared to do so;
- a risk management framework which encompasses the wide range of risks to which any BOFI and its board is exposed;
- a remuneration policy which rewards long term value creation, measured not simply by share price.

Board size, composition and qualification

Recommendation 1

To ensure that NEDs have the knowledge and understanding of the business to enable them to contribute effectively, a BOFI board should provide thematic business awareness sessions on a regular basis and each NED should be provided with a substantive personalised approach to induction, training and development to be reviewed annually with the chairman.

***NAPF**: Agreed. More generally we believe that there is a need for boards to reconsider how best to ensure that directors, particularly, but not exclusively, the non-executives, are briefed on key business issues. Shareholders would welcome details of that process and its effectiveness as part of the report on board evaluation.*

Recommendation 2

A BOFI board should provide for dedicated support for NEDs on any matter relevant to the business on which they require advice separate from or additional to that available in the normal board process.

***NAPF**: Agreed.*

Recommendation 3

NEDs on BOFI boards should be expected to give greater time commitment than has been normal in the past. A minimum expected time commitment of 30 to 36 days in a major bank board should be clearly indicated in letters of appointment and will in some cases limit the capacity of the NED to retain or assume board responsibilities elsewhere.

***NAPF**: The recommendation appears not to make sufficient allowance for the different demands arising from varying scale and complexity. In addition, time committed is greatest at the start of tenure and during any crisis and a director must be available at those times. Boards should ensure that directors have completed their induction and business briefings in a timely fashion. Failure to be available for key board meetings should be seen as raising questions about the suitability of the director.*

Recommendation 4

The FSA's ongoing supervisory process should give closer attention to both the overall balance of the board in relation to the risk strategy of the business and take into account not only the relevant experience and other qualities of individual directors but also their access to an induction and development programme to provide an appropriate level of knowledge and understanding as required to equip them to engage proactively in board deliberation, above all on risk strategy.

***NAPF**: Agreed. Shareholders would welcome disclosure of any FSA recommendations or comments relevant to assessing the effectiveness of the board.*

Recommendation 5

The FSA's interview process for NEDs proposed for major BOFI boards should involve questioning and assessment by one or more senior advisers with relevant industry experience at or close to board level of a similarly large and complex entity who might be engaged by the FSA for the purpose, possibly on a part-time panel basis.

***NAPF**: Agreed*

Functioning of the board and evaluation of performance

Recommendation 6

As part of their role as members of the unitary board of a BOFI, NEDs should be ready, able and encouraged to challenge and test proposals on strategy put forward by the executive. They should satisfy themselves that board discussion and decision-taking on risk matters is based on accurate and appropriately comprehensive information and draws, as far as they believe it to be relevant or necessary, on external analysis and input.

***NAPF**: This is a core function of the NEDs. They should have the skills and the resources needed to perform it properly. In order to encourage effective challenge of the executive, NEDs should report separately to shareholders on the quality of information provided and the extent to which they have sought external advice during the year.*

Recommendation 7

The chairman should be expected to commit a substantial proportion of his or her time, probably not less than two-thirds, to the business of the entity, with clear understanding from the outset that, in the event of need, the BOFI chairmanship role would have priority over any other business time commitment.

NAPF*: Agreed subject to the caveat noted in 3 above, regarding size and complexity. This would rule the chairman out of taking any other senior appointments and limit significantly his/her ability to serve on other boards.*

Recommendation 8

The chairman of a BOFI board should bring a combination of relevant financial industry experience and a track record of successful leadership capability in a significant board position. Where this desirable combination is only incompletely achievable, the board should give particular weight to convincing leadership experience since financial industry experience without established leadership skills is unlikely to suffice.

NAPF*: Agreed.*

Recommendation 9

The chairman is responsible for leadership of the board, ensuring its effectiveness in all aspects of its role and setting its agenda so that fully adequate time is available for substantive discussion on strategic issues. The chairman should facilitate, encourage and expect the informed and critical contribution of the directors in particular in discussion and decision-taking on matters of risk and strategy and should promote effective communication between executive and non-executive directors. The chairman is responsible for ensuring that the directors receive all information that is relevant to discharge of their obligations in accurate, timely and clear form.

NAPF*: Agreed. Again we suggest that further guidance be given to chairmen on disclosure of his/her execution of these responsibilities to shareholders.*

Recommendation 10

The chairman of a BOFI board should be proposed for election on an annual basis.

***NAPF**: Members are divided on the merits of annual elections but on balance there is a growing preference for them for all board members. In the absence of annual elections we support the ABI Guidance covering re-election after a major rights issue.*

Recommendation 11

The role of the senior independent director (SID) should be to provide a sounding board for the chairman, for the evaluation of the chairman and to serve as a trusted intermediary for the NEDs as and when necessary. The SID should be accessible to shareholders in the event that communication with the chairman becomes difficult or inappropriate.

***NAPF**: Agreed*

Recommendation 12

The board should undertake a formal and rigorous evaluation of its performance with external facilitation of the process every second or third year. The statement on this evaluation should be a separate section of the annual report describing the work of the board, the nomination or corporate governance committee as appropriate. Where an external facilitator is used, this should be indicated in the statement, together with an indication whether there is any other business relationship with the company.

***NAPF**: We strongly support annual board evaluation as a means of ensuring that it discharges its responsibilities effectively. We agree that external facilitation may not be necessary every year – this is a judgement for the board. By making the report on its outcome a separate section of the annual report it should develop a similar standing to the reports from the audit and remuneration committees, which would be of real benefit to shareholders. It should include statements setting out the nature of the evaluation; recommendations for improvement; and actions planned or taken in response.*

Recommendation 13

The evaluation statement should include such meaningful, high-level information as the board considers necessary to assist shareholders understanding of the main features of the evaluation process. The board should disclose that there is an ongoing process for identifying the skills and experience required to address and challenge adequately the key risks and decisions that confront the board, and for evaluating the contributions and commitment of individual directors. The statement should also provide an indication of the nature and extent of communication by the chairman with major shareholders.

***NAPF**: Agreed.*

The role of institutional shareholders: communication and engagement

Recommendation 14

Boards should ensure that they are made aware of any material changes in the share register, understand as far as possible the reasons for changes to the register and satisfy themselves that they have taken steps, if any are required, to respond.

***NAPF**: Agreed, in principle, although we see practical difficulties around disclosure of beneficial holdings, defining materiality and access to decision-makers at investing institutions. We would expect UK pension funds to support greater transparency by beneficial holders.*

Recommendation 15

In the event of substantial change over a short period in a BOFI share register, the FSA should be ready to contact major selling shareholders to understand their motivation and to seek from the BOFI board an indication of whether and how it proposes to respond.

***NAPF**: See 14 above.*

Recommendation 16

The remit of the FRC should be explicitly extended to cover the development and encouragement of adherence to principles of best practice in stewardship by institutional investors and fund managers. This new role should be clarified by separating the content of the present Combined Code, which might be described as the Corporate Governance Code, from what might most appropriately be described as Principles for Stewardship.

NAPF*: The NAPF is a member of the Institutional Shareholders' Committee. We see merit in the involvement of the FRC in owning a "Stewardship Code" as we believe that will encourage a better dialogue between shareholders and boards which is at the heart of a more effective corporate governance regime.*

Recommendation 17

The present best practice "Statement of Principles – the Responsibilities of Institutional Shareholders and Agents" should be ratified by the FRC and become the core of the Principles for Stewardship. By virtue of the independence and authority of the FRC, this transition to sponsorship by the FRC should give materially greater weight to the Principles.

NAPF*: Agreed*

Recommendation 18

The ISC, in close consultation with the FRC as sponsor of the Principles, should review on an annual basis their continuing aptness in the light of experience and make proposals for any appropriate adaptation.

NAPF*: We suggest that the reviews should be timed to coincide with the periodic reviews of the Combined Code.*

Recommendation 19

Fund managers and other institutions authorised by the FSA to undertake investment business should signify on their websites their commitment to the Principles of Stewardship. Such reporting should confirm that their mandates from life assurance, pension fund and other major clients normally include provisions in support of engagement activity and should describe their policies on engagement and how they seek to discharge the responsibilities that commitment to the Principles entails. Where a fund manager or institutional investor is not ready to commit and to report in this sense, it should provide, similarly on the website, a clear explanation of the reasons for the position it is taking.

***NAPF**: Agreed*

Recommendation 20

The FSA should encourage commitment to the Principles of Stewardship as a matter of best practice on the part of all institutions that are authorised to manage assets for others and, as part of the authorisation process, and in the context of feasibility of effective monitoring to require clear disclosure of such commitment on a "comply or explain" basis.

***NAPF**: Stewardship cannot be described as best practice for all asset managers. Myners' Principle 5 clearly supports the ISC Principles as best practice for pension funds and recommends that an engagement policy be incorporated into a fund's Statement of Investment Principles. However, in reality the situation for larger pension funds is less straightforward, given their exposure to a wide range of asset classes, including private equity and hedge funds. The primary emphasis should therefore be on investors adopting a policy on stewardship which is appropriate to the mandate and that policy being effectively overseen by the client, with appropriate disclosures. Members are unconvinced that there would be real benefit from incorporating compliance with the Principles into the authorisation process..*

Recommendation 21

To facilitate effective collective engagement, a Memorandum of Understanding should be prepared, initially among major long-only investors, to establish a flexible and informal but agreed approach to issues such as arrangements for leadership of a specific initiative, confidentiality and any conflicts of interest that might arise. Initiative should be taken by the FRC and major UK fund managers and institutional investors to invite potentially interested major foreign institutional investors, such as sovereign wealth funds and public sector pension funds, to commit to the Principles of Stewardship and, as appropriate to the Memorandum of Understanding on collective engagement.

***NAPF**: We agree that improved collaboration between investors is desirable and are pleased that both the Takeover Panel and the FSA have restated their policies albeit* *that some investors still have reservations about the constraints which may apply.However we remain to be convinced that the proposed MoU will add much to the current structures.*

For many years the NAPF's Case Committees have offered a facility for its members. We expect that the initiative set out here would be the exception rather than the rule, as the many informal channels for co-operation are preferred by investors. However, the important part of the proposal would be the commitment of several institutions to collaborate on a case by case basis so that issues could be addressed quickly and effectively.

We see the recommendation on foreign investors as a separate issue and worthy of consideration on its own. There is a real need for greater collaboration between international investors as share ownership becomes more diverse so the suggestion that they might commit to the Principles of Stewardship or the MoU is to be welcomed.

Recommendation 22

Voting powers should be exercised, fund managers and other institutional investors should disclose their voting record, and their policies in respect of voting should be described in statements on their websites or in other publicly accessible form.

***NAPF**: Agreed. However there will be disagreements as to what constitutes a "voting record". We see little value and considerable expense in the US-style reporting. The industry should develop best practice guidance on the contents of such reports.*

Governance of risk

Recommendation 23

The board of a BOFI should establish a board risk committee separately from the audit committee with responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy. In preparing advice to the board on its overall risk appetite and tolerance, the board risk committee should take account of the current and prospective macro-economic and financial environment drawing on financial stability assessments such as those published by the Bank of

England and other authoritative sources that may be relevant for the risk policies of the firm.

NAPF*: We see real merit in a risk committee which would review the broader risks facing an organisation as well as the reports on internal risk controls, where disclosure to shareholders is already extensive in many cases.*

Recommendation 24

In support of board-level risk governance, a BOFI board should be served by a CRO who should participate in the risk management and oversight process at the highest level on an enterprise-wide basis and have a status of total independence from individual business units. Alongside an internal reporting line to the CEO or FD, the CRO should report to the board risk committee, with direct access to the chairman of the committee in the event of need. The tenure and independence of the CRO should be underpinned by a provision that removal from office would require the prior agreement of the board. The remuneration of the CRO should be subject to approval by the chairman or chairman of the board remuneration committee.

NAPF*: Agreed*

Recommendation 25

The board risk committee should have access to and, in the normal course, expect to draw on external input to its work as a means of taking full account of relevant experience elsewhere and in challenging its analysis and assessment.

NAPF*: Agreed*

Recommendation 26

In respect of a proposed strategic transaction involving acquisition or disposal, it should as a matter of good practice be for the board risk committee to oversee a due diligence appraisal of the proposition, drawing on external advice where appropriate and available, before the board takes a decision whether to proceed.

***NAPF**: Agreed. The recommendations of the risk committee should form part of the disclosures to shareholders relating to such a transaction.*

Recommendation 27

The board risk committee (or board) risk report should be included as a separate report within the annual report and accounts. The report should describe the strategy of the entity in a risk management context, including information on the key exposures inherent in the strategy and the associated risk tolerance of the entity and should provide at least high level information on the scope and outcome of the stress-testing programme. An indication should be given of the membership of the committee, of the frequency of its meetings, whether external advice was taken and, if so, its source.

***NAPF**: Agreed. We note that current risk reports focus excessively on operational risk and less on balance sheet or strategic risk.*

Remuneration

Recommendation 28

The remit of the remuneration committee should be extended where necessary to cover all aspects of remuneration policy on a firm-wide basis with particular emphasis on the risk dimension.

***NAPF**: Agreed*

Recommendation 29

The terms of reference of the remuneration committee should be extended to oversight of remuneration policy and remuneration packages in respect of all executives for whom total remuneration in the previous year or, given the incentive structure proposed, for the current year exceeds or might be expected to exceed the median compensation of executive board members on the same basis.

***NAPF**: Agreed*

Recommendation 30

In relation to executives whose total remuneration is expected to exceed that of the median of executive board members, the remuneration committee report should confirm that the committee is satisfied with the way in which performance objectives are linked to the related compensation structures for this group and explain the principles underlying the performance objectives and the related compensation structure if not in line with those for executive board members.

***NAPF**: Agreed*

Recommendation 31

The remuneration committee report should disclose for "high end" executives whose total remuneration exceeds the executive board median total remuneration, in bands, indicating numbers of executives in each band and, within each band, the main elements of salary, bonus, long-term award and pension contribution.

***NAPF**: Agreed. However, further consideration needs to be given to the definition of remuneration and in particular the valuation of share awards.*

Recommendation 32

Major FSA-authorised BOFIs that are UK-domiciled subsidiaries of non-resident entities should include in their reporting arrangements with the FSA disclosure of the remuneration of "high end" executives broadly as recommended for UK-listed entities but with detail appropriate to their governance structure and circumstances agreed on a case by case basis with the FSA. Disclosure of "high end" remuneration on the agreed basis should be included in the annual report of the entity that is required to be filed at Companies House.

***NAPF**: Agreed*

Recommendation 33

Deferral of incentive payments should provide the primary risk adjustment mechanism to align rewards with sustainable performance for executive board members and executives whose remuneration exceeds the median for executive board members. Incentives should be balanced so that at least one-half of variable remuneration offered in respect of a financial year is in the form of a long-term incentive scheme with vesting subject to a performance condition with half of the award vesting after not less than three years and of the remainder after five years. Short-term bonus awards should be paid over a three year period with not more than one-third in the first year. Clawback should be used as the means to reclaim amounts in limited circumstances of misstatement and misconduct.

NAPF*: We favour the deferral and clawback mechanisms but question whether the degree of prescription set out above is appropriate in every instance. Long term awards should be subject to performance conditions at grant and at vesting.*

Recommendation 34

Executive board members and executives whose total remuneration exceeds that of the median of executive board members should be expected to maintain a shareholding or retain a portion of vested awards in an amount at least equal to their total compensation on a historic or expected basis, to be built up over a period at the discretion of the remuneration committee. Vesting of stock for this group should not normally be accelerated on cessation of employment other than on compassionate grounds.

NAPF*: Agreed.*

Recommendation 35

The remuneration committee should seek advice from the board risk committee on an arm's-length basis on specific risk adjustments to be applied to performance objectives set in the context of incentive packages; in the event of any difference of view, appropriate risk adjustments should be decided by the chairman and NEDs on the board.

NAPF*: Agreed*

Recommendation 36

If the non-binding resolution on a remuneration committee report attracts less than

75 per cent of the total votes cast, the chairman of the committee should stand for re-election in the following year irrespective of his or her normal appointment term.

***NAPF**: Agreed*

Recommendation 37

The remuneration committee report should state whether any executive board member or senior executive has the right or opportunity to receive enhanced pension benefits beyond those already disclosed and whether the committee has exercised its discretion during the year to enhance pension benefits either generally or for any member of this group.

***NAPF**: Remuneration committees need to consider all aspects of any proposed enhancement and ensure that there is full disclosure of the rationale for it. It may be appropriate to state in the annual report if there are any terms in a director's contract which might lead to payments which would be in breach of best practice (broadly "payments for failure")*

Recommendation 38

The remuneration consultants involved in preparation of the draft code of conduct should form a professional body which would assume ownership of the definitive version of the code when consultation on the present draft is complete. The proposed professional body should provide access to the code through a website with an indication of the consulting firms committed to it; and provide for review and adaptation of the code as required in the light of experience.

***NAPF**: The code's value lies in its being applied by remuneration committees in appointing and monitoring their consultants. Investors should welcome statements by companies that they have assessed the performance of their consultants in the light of the requirements of the code.*

Recommendation 39

The code and an indication of those committed to it should also be lodged on the FRC website. In making an advisory appointment, remuneration committees should employ a consultant who has committed to the code.

NAPF*: Commitment to the Code should be on a comply or explain basis.*