NAPF

Securing the future of pensions

The Kay Review of UK Equity Markets and Long-Term Decision Making

A response by the National Association of Pension Funds

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About the NAPF

The National Association of Pension Funds (NAPF) is the UK's leading voice for workplace pensions. We represent all types of workplace pension scheme, including defined benefit, defined contribution, group personal pensions and statutory schemes such as those in local government.

Between them, our members have combined assets of approximately £700 billion, and operate some 1,200 pension schemes. Our membership also includes over 400 providers of essential advice and services to the pensions sector. This includes accounting firms, solicitors, fund managers, consultants and actuaries.

Introduction

The NAPF welcomes the Kay Review. It is particularly important that we reconsider the issues raised in the Review at a time of economic and regulatory upheaval. We seek to ensure that the outcome is positive for pension funds and their beneficiaries.

Pension funds, as is well known, have reduced materially their exposure to UK equities in recent years. However, in the case of DB pension funds, their interest in a successful UK corporate sector extends beyond that of an equity investor to that of an unsecured creditor, by virtue of the sponsor backing of private sector schemes.

It should not be overlooked that the emergence of DC pensions as the primary pensions savings for most employees heralds a significant change to the way in which pension funds are managed and to the relationship between funds and their beneficiaries.

Given the growing geographical diversity of the shareholder base for most companies it is unlikely that many will in future be able to rely on the support of a few stable, long-term shareholders. The onus is therefore on boards to develop a strategy, assess its execution and communicate effectively to investors.

From our perspective there are several outcomes which we seek from the Review which would support the realisation of its goals. These are:

- A regulatory environment which is more supportive of longer term risk-taking by pension fund investors. Specific obstacles include accounting standards; inflexibility around recovery plans; and Solvency II (or its pension fund equivalent).
- The encouragement of greater transparency around investment fees and charges.
- Material improvements to the voting "plumbing" and the related issue of stock lending.
- A supportive regime for collaboration among institutional investors.

In addition the NAPF will respond to the BIS consultations on remuneration and narrative reporting which are relevant to the Kay Review.

In addition to this response we enclose our work on IAS 19, our 2010 Annual Survey (we will forward the 2011 Annual Survey shortly), the 2010 Engagement Survey (the 2011 Survey will be published on the NAPF website on 6th December) and our Review of the Myners Principles. The NAPF Corporate Governance Policy is available on the NAPF website.

Response to individual questions

Kay Review Terms of Reference:
To examine the mechanisms of corporate control and accountability provided by UK equity markets and their impact on the long term competitive performance of UK businesses, and to make recommendations.

The terms of reference set out ten broad questions for the review to consider. The NAPF response to these questions is set out below.

1. **Whether the timescales considered by boards and senior management in evaluating corporate risks and opportunities, and by institutional shareholders and asset managers in making investment and governance decisions, match the time horizons of the underlying beneficiaries. We would particularly welcome evidence on:**
    a. **the relationship between reporting timescales and those used for internal planning and appraisal;**
    b. **what timescales are used by companies in investment appraisal;**
    c. **how companies review investment in intangible assets (e.g. corporate reputation, workforce skills);**
    d. **what timescales are used by equity investors, and in particular institutional investors such as pension scheme trustees, who appoint fund managers in determining investment strategy.**

NAPF Response:

The evidence from industry surveys is that manager appointments typically last for around five years or more. Drivers for change include: poor performance relative to the benchmark or competition; changes to investment manager personnel, investment style or ownership; or asset allocation strategy changes. Investment manager changes should not be confused with changes to investment strategy, with the latter being subject to less frequent reviews, often linked to the triennial actuarial valuation.

The reduction in UK equity holdings has come about as a result of the move by investors around the world to diversify outside their domestic market as well as the growing maturity of many DB schemes. Data on pension fund assets shows that the trend away from UK equities has occurred over a long time, suggesting that industry time horizons are quite extended with few abrupt changes in the mix.
There is also a need to consider the extent to which short-term decision making is a problem for investors and companies. Short-termism in equity markets leads to an increased turnover of assets, thus allowing for easier and cheaper trading and greater liquidity. This increase of activity in equity markets does not necessarily detract from what the true long-term investor is trying to achieve.

2. How to ensure that shareholders and their agents give sufficient emphasis to the underlying competitive strengths of the individual companies in which they invest. We would particularly welcome evidence on:

   a. how equity analysts and asset managers assess the competitive advantages of companies;

   b. the extent to which trading on equity markets is guided by analysis of underlying corporate performance, and the extent to which it is driven by analysis of short-term market trends;

   c. how have technological advances such as automated trading affected investment decisions in equity markets;

   d. whether corporate managers feel able to communicate effectively about issues related to the competitive position of their businesses.

NAPF Response:

Most pension funds delegate the day-to-day management of their asset to specialist asset management firms. Viewed from the client perspective, the range of investment styles available has grown considerably and it is not uncommon for a fund to employ managers with different styles: index tracking, research-based and momentum-driven approaches are all employed. Pension fund investments in hedge funds and private equity remain small relative to public securities.

The cost of trading, as measured by spreads and commissions, for larger stocks at least, appears to have fallen and when coupled with computerised trading techniques such as program trades has probably led to some increase in portfolio turnover, albeit much less than the market headline numbers would suggest. Funds and their advisers often monitor turnover as a means of assessing whether the manager is following his stated investment policy.

3. Whether the current functioning of equity markets gives sufficient encouragement to boards to focus on the long-term development of their business. We would particularly welcome evidence on:

   a. whether changes in reporting obligations have influenced the perspectives and timescales of managers and boards, and whether these changes in perspectives and timescales help or hinder long-term decision making;

   b. how the perspectives of managers and boards vary between listed companies, companies whose equities are traded on AIM and PLUS

   c. whether publicly traded companies pay too much attention (or feel obliged to pay too much attention) to short-term fluctuations in their share prices;

   d. whether companies feel that their engagement with fund managers and analysts is properly focused on the competitive capabilities of the business.

NAPF Response:

There is a strong sense among our members that quarterly results reporting and trading updates bring excessive focus to the short term with little or no benefit for the long term investor.

In addition, it is usual for a significant part of senior management's remuneration to be linked to relative share price performance. While the vesting period is usually three years, success depends heavily on the start and end prices. Given the very large sums involved it would be extraordinary if those executives concerned were not incentivised by share price performance over the shorter term, potentially at the expense of the longer term success of the business. Considerable attention has been given to the quantum of executive remuneration and the apparent weak links between pay and longer term performance. We suggest that current market practices on remuneration fail to encourage long-term thinking by many senior executives.

The NAPF Corporate Governance Policy has recently been revised to place greater emphasis on the director nominations process, by seeking a fuller description of the relevant skills and experience which a director brings to the board. A strong and effective board should be better able to focus on the longer term and ignore the noise of the market. Investors increasingly expect companies to report on how effectiveness is assessed, for example through the use of independent board evaluations.

4. **Whether Government policies directly relevant to individual quoted companies (such as regulation and procurement) sufficiently encourage boards to focus on the long term development of their businesses. We would particularly welcome evidence on:**
    a. **whether government policies encourage undue focus on cost cutting, or otherwise damage the ability of firms to engage in long-term investment and the building of sustainable competitive advantage;**
    b. **whether government policies aimed at facilitating long-term investment by companies have been effective and whether there are other ways Government could support long-term business growth.**

NAPF Response:

No comment

5. **Whether Government policies directly relevant to institutional shareholders and fund managers promote long-term time horizons and effective collective engagement. We would particularly welcome evidence on:**
    a. **whether pension regulation, insurance regulation, supervision of charitable endowments and regulatory requirements for asset managers lead to excessive emphasis on benchmarking and on short-term performance measurement;**
    b. **whether the broader regulation of equity markets has an impact on the investment timescales of market participants;**

c. **whether the regulation of contact between companies and investors is an obstacle to effective engagement.**

NAPF Response:

We are concerned that Solvency II pushes institutions into investing in shorter-term assets. Whilst this might be appropriate for general insurance, we do not believe it is necessarily appropriate for pension funds, given their long-term liabilities. Indeed, this approach increases risk by generating a greater divergence between the nature of the assets and the life of the liabilities.

Solvency II is already having a significant impact on the investment processes of the insurance companies to which it applies, obliging them to move from being long-term shareholders to being shorter-term holders of bonds and other assets. This is unfavourable to long-term share ownership and its potential positive influence on long-term investment in the future of the European economy.

We are very concerned that the European Commission is now considering how Solvency II can be adapted and applied to pension schemes, through the current review of the main EU pensions legislation – the Directive for Institutions for Occupational Retirement Provision. We note that the Commission's Call for Advice to EIOPA on review of the 'IORP' Directive raises the prospect of a harmonised approach to technical provisions, drawing on Articles 75-86 of Solvency II. Not only would this increase scheme funding requirements, potentially accelerating the closure of defined benefit schemes and the shift towards defined contribution arrangements, it would also lead to a very significant shift in the current investment approach of some of Europe's largest long-term investors. This would be decidedly unhelpful to long-termism in the market.

We would also draw attention to the Markets in Financial Instruments Directive (MiFID), whose focus on trading issues may have resulted in a greater interest in trading strategies. This focus on improving liquidity may also contribute to short-termism in investment markets.

Pension regulation has driven funds and their sponsors increasingly to take a shorter term view. The NAPF has written at length on IAS 19 which it sees as driving sponsors to place excessive emphasis on accounting measures of solvency. Likewise the Pensions Regulator's guidance on recovery plans encourages schemes to reach full funding over quite short time horizons.
More generally, our members have had to deal with a regulatory environment which has been in constant flux for much of the past fifteen years or more. While most of these changes do not deal directly with investment matters there has all too often been a knock-on consequence for funds' investment policies which was not considered when evaluating the merits of new regulations.

The availability of cheap index tracker funds has certainly given increased focus to index benchmarks, which we do not see as unwelcome in themselves. However they can detract from the focus on earning a positive return on the funds invested. More recently, pension funds have become increasingly concerned about the growing number of UK listings by companies which have no business activities in the UK and are often controlled by foreign shareholders. This has led to a shift in the structure of the FTSE Indices, increasing perceived risk on three counts: greater exposure to the

resources sector; weaker corporate governance standards; and more related party transactions where disclosure required by the regulators is often inadequate for minority investors such as UK pension funds

In the UK there are few obstacles to effective engagement between companies and their shareholders. However, the European Transparency Directive has been cited by some funds as potential barrier to collaboration, given that an intention to vote at a company meeting in collaboration with other shareholders could require disclosure ahead of the meeting date. This presents potentially severe practical problems to investors and could inhibit effective collaboration in Europe as a whole.

6. Whether the current legal duties and responsibilities of asset owners and fund managers, and the fee and pay structures in the investment chain, are consistent with these long-term objectives. We would particularly welcome evidence on:

   a. whether there is a more rapid turnover of asset managers and whether this makes it more difficult for these managers to take a long term view of the companies in which they invest;

   b. how individual asset managers are rewarded, and their performance measured, and whether this gives insufficient incentive for them to take a long term view of the companies in which they invest;

   c. whether there are agency problems in the objectives and operations of asset managers that may be deleterious to the interests of the corporate sector or savers;

   d. how other intermediaries and market participants are remunerated and what impact this has on their incentives and those of their clients.

NAPF Response:

The “current legal duties and responsibilities” of pension funds and their trustees are generally appropriate to DB schemes. NAPF members would be concerned if additional regulatory burdens were to be placed on pension funds which might conflict with their primary responsibility to members. There is increasing focus among DB pension funds on liabilities and therefore on the longer term.

As noted above we do not believe that manager turnover has increased in recent years, despite poor returns and the consolidation of the asset management industry. In addition, client turnover should not be an impediment to longer term investment.

We believe that the FSA regulations on asset manager pay provide better alignment between client and manager than was the case previously. It should be noted that managers are rewarded for portfolio returns measured against a benchmark. Such assessment should take account of the risk appetite of the mandate and any constraints imposed by the client.

The NAPF announced, at its Annual Conference in October, that it would be calling an industry Summit to promote transparency in pensions costs and charges. This was in response to concerns raised by both the Workplace Retirement Income Commission and the Pensions Regulator that people did not understand the costs of their pensions. This initiative has been welcomed by Pensions Minister, Steve Webb MP. To inform discussions at the Summit and initiate the development of a Code of Practice, the NAPF will shortly publish a discussion paper.

7. **Whether there is sufficient transparency in the activities of fund managers, clients and their advisors, and companies themselves, and in the relationships between them. We would particularly welcome evidence on:**
    a. **whether the existing rules on disclosure of material stakes are excessive or inadequate;**
    b. **whether asset managers should be subject to more extensive disclosure requirements, e.g. of costs and remuneration structures;**
    c. **whether the growth of investment consultants has encouraged or discouraged engagement by share owners with companies;**
    d. **whether the overall costs of intermediation are understood by beneficiaries, and are proportionate to the value of the services provided;**
    e. **whether investors have sufficient information to understand the investment approaches of asset managers and to judge whether they are aligned with their investment objectives and timescales.**

NAPF Response:

As noted earlier we have concerns about the Transparency Directive, which presents a number of practical difficulties to investors. The current rules on disclosure of material stakes in the UK strike the right balance between the desirability of full disclosure and excessive operational complexity which would result if the threshold was set too low.

There is a need for the asset management industry to improve its disclosure of charges, costs and remuneration structures in the light of the likely growth of the industry, following the introduction of auto-enrolment to pension funds from 2012.

The investment consultants have neither encouraged nor discouraged shareholder engagement, until recently following the introduction of the Stewardship Code. As advisers to pension funds they are responsible for monitoring their asset managers – this ought to include engagement activity.

We believe that pension fund beneficiaries have a poor understanding of the costs incurred in managing their investments. The work currently being undertaken by the NAPF aims to shed some light into these costs.

Pension fund trustees are supplied with a considerable volume of information about their managers' investment process and are therefore in a good position to judge the suitability of the approach to their investment objectives, when supported well by their advisers

8. The quality of engagement between institutional investors and fund managers and UK quoted companies, and the importance attached to such engagement, building on the success of the Stewardship Code. We would particularly welcome evidence on:

   a. whether the measures taken to stimulate engagement by investors with companies have been sufficiently effective;

   b. whether the corporate governance activities of asset management businesses are sufficiently integrated with the decisions of fund managers.

NAPF Response:

The surveys carried out by the IMA and the NAPF indicate that the Stewardship Code has had a beneficial impact on both the quantity and quality of engagement. However, it appears that many asset managers have yet fully to integrate these activities with their investment decision-making.

The focus of the Stewardship Code has to date been mainly on assessing effective corporate governance standards rather than company strategy and commercial success. Given time we expect that it will form an increasingly important part of trustees' monitoring as its application can shed useful light into a manager's investment decisions.

9. The impact of greater fragmentation and internationalisation of UK share ownership, and other developments in global equity markets, on the quality of engagement between shareholders and quoted companies. We would particularly welcome evidence on:

   a. what has been the effect of the internationalisation of UK equity markets on the priorities of companies and fund managers;

   b. whether the growth in overseas ownership of UK equities, and in the overseas activities of UK listed companies, has affected engagement between UK investment institutions and UK companies.

NAPF Response:

Companies frequently complain that it has become increasingly hard for them to identify their shareholders. This is partly due to the globalisation of investors but also to the growth of stock lending and the complex chain of custody arrangements. We believe that the interests of long term investors would be well served by better disclosure of underlying beneficial owners and revisions to the rules governing stock lending so that voting authority rested with the party with an economic interest in the company.

10. Likely trends in international investment and in the international regulatory framework, and their possible long term impact on UK equity markets and UK business. We would particularly welcome evidence on

   a. how UK asset managers, and UK companies, expect the pressures on them to change with further internationalisation of equity investment;

   b. whether recent or planned regulatory actions by authorities outside the UK, and particularly regulatory policy developments at EU level, will affect engagement between asset managers and the companies in which they invest, and the ability of companies to respond to that engagement.

NAPF Response:

Nothing to add to earlier comments.