Securing the future of pensions

PARLIAMENTARY COMMISSION ON BANKING STANDARDS

CALL FOR EVIDENCE

1. **Executive summary**

1.1. The NAPF is the leading voice of workplace pensions in the UK. We speak for 1,300 pension schemes which collectively hold assets of £900bn providing benefits to 16 million people. We represent over 400 providers of essential advice, products and services to the pensions industry.

1.2. Pension funds have a real and long-term interest in the issues being addressed by the Commission. Bank shares form a material part of most asset portfolios and funds are major consumers of wholesale banking services, from custody to stock market transactions to foreign exchange dealing.

1.3. Our members have been impacted by the failings in the standards of governance and lack of a positive culture within some of the world's largest banks which have led to significant losses in shareholder value and thus a direct impact on pension funds. Episodes such as the manipulation of Libor and Euribor; the mis-selling of PPI to individuals and interest swap products to SMEs; the failure to prevent money laundering and unauthorised transactions involving customers' money demonstrate why the NAPF believe improvements are needed.

1.4. Banks are heavily regulated institutions and while in some areas further regulatory intervention may be required – such as those proposed by the Independent Commission on Banking - it is not possible to legislate for a good culture.

1.5. What is most needed is greater independence and professionalism amongst those charged with overseeing banking operations, including, crucially, the non-executive directors. A good culture needs to stem from the board recognising its responsibilities to act in the long term interests of their shareholders and customers. As Lord Turner recently suggested reforming the banking culture has to start with the most senior levels of management asking searching questions of their own operations, ensuring they are truly delivering in their consumers' interest.

1.6. Recent reforms implemented following both the Turner and Walker reviews are only beginning to bed in, it is vital therefore to avoid responding in a manner which would be to the detriment of customers, shareholders and the broader economy. Instead the banking industry needs to act to restore and protect its reputation and recover the trust of its customers and shareholders.

2. **The culture in UK banking**

2.1. There has understandably been a significant focus over the past few years on the regulation of the banking sector, both in the UK and internationally. Recent events however, have highlighted that there is a limit to what regulation can achieve – it is not possible to regulate for good behaviour.

2.2. Recent disclosures have brought to light a worrying culture within many banks. While most incidents involved only a small number of individuals directly, it appears a larger number

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were often aware and the banks' internal compliance functions failed to either spot or stop these activities.

2.3. It has been suggested that direct or indirect awareness or involvement in such activities stretched from trading floors, through compliance functions, audit functions and on up to the executives at the top of firms. It is the responsibility of the executives to set and live the culture, ethos and ethics of the firm which they are charged with running, to lead by example and instill this through their firm.

2.4. As with the outcry which followed 2008 and led to the wave of regulation aimed at the financial services industry, the justified recent public outcry at the behaviors of a minority in the banking industry has been the straw that has broken the camel's back. The public, shareholders and regulators rightly expect the industry to put its house in order.

2.5. We believe that this behavioural change needs to primarily come from within the sector itself, although politicians, regulators, shareholders and the public should monitor this closely and make clear the expectations the industry should meet - this should include the ability to be able to hold to account those who stray, through the criminal courts if appropriate.

2.6. What is needed is to encourage compliance and individual responsibility at all levels in organisations to promote a healthy culture and foster trust-based relationships. It is for others to determine the best way to achieve this end; however, some have suggested that the industry may wish to consider a professional register and code of conduct with stringent robust sanctions.

3. **The role of shareholders**

3.1. The providers of equity capital, typically institutional investors, such as pension funds, have played a key role in supporting the return to health of many financial institutions in the recent past by providing the additional permanent capital required to reduce leverage and cover for losses incurred during the financial crisis.

3.2. By way of compensation for their provision of capital, investors have the right to engage with and seek to influence the strategic direction of the company in order to protect and hopefully increase the value of their investment. Shareholders, however, are not involved in the day-to-day operations of a firm; instead they rely on the board of directors to oversee and govern management and to make corporate decisions on their behalf.

3.3. To date, 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.

3.4. This culture needs to be reversed and following the 2008 crisis there have been signs that this is becoming understood by those across the industry. The culture of these institutions is currently working against the interests of the providers of capital. It now requires those at the top of the industry to grasp the nettle.

3.5. Our members understand the risks posed by an individualist short-term culture. Pension funds and other institutional investors regularly engage with companies on routine and more serious matters and, in their meetings, the culture being set within the company from the top is a topic that is increasingly discussed.

3.6. Shareholders already have the ability to hold boards to account through the annual re-election of directors. This ultimate sanction can and should be utilised by shareholders where there is clear evidence of poor performance by the individual or the company and engagement has not resulted in a satisfactory response.

4. **Corporate governance vs. regulation**

4.1. Corporate governance is about behaviours and how a company in any sector, not just financial services, is directed and controlled. Good governance is ultimately about the behaviours and culture within an organisation, whether it is effectively managed; decisions are sound and success sustainable.

4.2. The level of regulatory supervision of financial institutions prior to the crisis was widely accepted to have been inappropriately low. The Walker Review made a significant contribution in promoting increased corporate governance standards in financial institutions in the wake of the financial crisis. While it is still early days for the Walker Review recommendations, the early signs are positive.

4.3. There are concerns however, that some of the other elements of the recent wave of regulatory reforms risk disempowering shareholders and making them less effective in holding boards to account

4.4. In banks, especially those that are Systemically Important Financial Institutions (SIFIs), it is clear that regulators have a role to play. But there needs to be a balance between the constraints of regulation and allowing boards to decide what is in shareholders' best interests. Regulation may undermine the role played by shareholders who, as owners of companies and providers of risk capital, are best placed to hold boards to account.

4.5. In the context of the Commission's inquiry, it is our view that prescriptive rules cannot guarantee good behaviour – this can only be encouraged, not prescribed. Increasing intrusiveness may be counterproductive – we give two examples below.

4.6. At present, the FSA approve individuals who perform controlled functions to ensure that the individuals concerned are 'fit and proper'. This approval process by the regulator limits the scope for shareholders to engage in the nominations process. We therefore see merit in the FSA formally seeking investor views on the qualities of nominated directors, allowing shareholders to help shape the culture of those who represent their interests on the boards of banks.

4.7. There are also increasing requests for the FSA to attend board meetings, however, the FSA's presence could in fact inhibit board discussion and discourage frank debate, thereby undermining board effectiveness. The recent events with Barclays for example raises questions about the regulator's role if there are failings at a firm where the FSA has been an attendee at board meetings and had significant concerns about a firm which were not then shared with the firms' shareholders. In such instances there should be disclosures from the company and the regulator of any pertinent points of concern which may impact on shareholder value; this could be facilitated through the Investors Forum recommended by Professor Kay in his recent report.

5. **Remuneration**

5.1. The situation is perhaps even more extreme with regards to remuneration, where the detailed prescription on pay structures and levels set by the FSA and other regulators mean that the role for shareholders risks being extremely limited. EU regulations are also following a similar pattern – with the Capital Requirements Directive IV (CRD IV) currently proposing to impose strict caps on bonuses. Some of the proposals under CRD IV take corporate governance issues outside the sphere of company law and into a banking compliance world.

5.2. We do firmly believe that there is a need for a fundamental rethink of executive pay structures to ensure better alignment between rewards to management and the interests of long-term investors such as pension funds. This is needed for remuneration structures of executives in all sectors - we do not support a separate prescriptive regime for executives in the financial sector. It is the case however, that the incentives provided by remuneration structures are perhaps more pertinent in institutions such as banks.

5.3. We believe that remuneration schemes are often not working sufficiently well to deliver their intended purposes. Often due to the best of intentions, complexity has built up which is now a barrier to understanding and motivation creating perverse behaviour. Moreover, remuneration may have been used as a short cut to the more difficult task of driving the right tone from the top and culture and alignment within companies.

5.4. Reforms on pay should therefore focus on simplicity and alignment both to companies' ultimate owners via long-term share ownership as well as the culture and behaviour desired and expected by the board.

5.5. It is crucial that changes already introduced and those on the horizon are given time to embed. Changes in behaviour do take time and layering change upon change without due consideration of whether the initial changes have had the desired impact is likely to cause confusion, could lead to unintended consequences and risks shifting focus away from changing behaviours to a tick box approach.

6. **Delivering a better culture**

6.1. The board's role in defining corporate culture is considerable. However, the primary responsibility lies with the executives, with the board's role focussed on setting the values by which it intends to operate; its attitude to integrity, risk, safety and the environment; its culture; its value proposition to investors; and plans for development (ii) ensuring the heads of the organisation have the right cultural approach; and, (iii) holding management to account in respect of these issues.

6.2. The board should agree what the culture ought to be, and certainly can ensure that individuals with the wrong cultural approach are not at the top of the organisation, but shaping and delivering on that agreed culture is the responsibility of the executive team. The non-executive directors can critically assess their performance in delivering this – just as can the firms' shareholders and regulators.

7. **Remedies**

7.1. Whilst the NAPF is supportive of regulation in circumstances where it is likely to add value, it is not always a means for achieving success. It is clear that culture change cannot be required by legislation, nor guaranteed by corporate governance structures. The cost of getting it wrong, not least in terms of serious damage to corporate reputation, should be a significant incentive to financial institutions to think about what steps they need to take to get it right.

7.2. It is not for investors to prescribe a financial services firm's culture. Their role is to ensure that the right people are appointed to the board which incentivises a culture that delivers the right outcomes – a role which is more difficult to perform in relation to banks due to the issues explained previously.

7.3. Remuneration structures have an important role to play in this and often the focus has been on increasing profit in the short-term, as opposed to return on assets and prudent management of leverage. There has been much progress on this and investors are becoming more proactive than was previously the case.

7.4. Executives and other industry leaders need to grasp the nettle and seek to change the culture of their industry. The industry needs a culture of responsible risk-taking in which sustainable shareholder value creation, including through the value of services provided to the entity's clients, is the embedded objective of all, where reward can be high but only where performance justifies it, in which risk management systems are well-built and operate effectively, and where responsible employees can be confident that concerns they may have can be raised and addressed without career-limiting implications.

7.5. The risk is that rules will inevitably lead to formal, legal compliance with the letter rather than the spirit of the law or regulation. In turn this leads to behaviour that is focused on formal, defensive compliance (which easily drifts into a gaming of the system) rather than the sort of culture and approach that we seek.

7.6. Changes in culture and behaviours take time and recent amendments to the corporate governance framework introduced since the financial crisis should be given a period to embed before further regulatory action is taken. Any case for further change needs to consider whether measures already introduced have had the desired effect of changing behaviours. It is crucial that regulators do not further usurp the role of boards, or of shareholders, thereby threatening the chain of accountability. Instead the banking industry needs to act to restore and protect its reputation and recover the trust of its customers and shareholders.

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