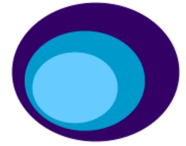

BUSINESS, INNOVATION AND SKILLS SELECT COMMITTEE
INQUIRY INTO THE KAY REVIEW OF UK EQUITY MARKETS AND LONG-TERM DECISION MAKING

1. Introduction

1.1. The NAPF is the leading voice of workplace pensions in the UK. We speak for 1,300 pension schemes with some 16 million members and assets of around £900 billion. NAPF members also include over 400 businesses providing essential services to the pensions sector.

1.2. We welcome the Committee's undertaking of this inquiry into the Kay Review of UK Equity Markets and Long-Term Decision Making. This is an important issue and one which is of considerable interest to our members; 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.

1.3. The NAPF warmly welcomed the government's launch of the Kay review as well as the government's response to Professor Kay's report, both of which we gladly hosted.

1.4. The NAPF believes that equity markets must work more effectively in the long-term interests of investors and savers, who need to be able to see that they are getting value for money. The analysis presented by professor Kay and which was endorsed by the Secretary of State for Business, Innovation and Skills, Vince Cable MP, was sound and rightly highlighted the range of challenges that need addressing.

1.5. In its response, the Government acknowledged that there had been broad acceptance of Professor Kay's analysis, though this was accompanied by some scepticism about whether change is achievable, and whether the Government, UK companies and the investment industry can bring it about.

1.6. While many of the issues we identified in our submission to the Kay review were addressed in varying degrees in the final report, we were disappointed that some of the positive discussion in Professor Kay's interim report failed to make its way into any of the recommendations within the final report. While to a very large extent the NAPF endorses Kay's conclusion that the chain of intermediaries in the investment process is too large and costly, we were underwhelmed with the proposed solution to address this which largely boiled down is: leave it to the market.

1.7. However, by endorsing Professor Kay's recommendations, the Government is giving a clear direction of travel, which will help pension funds play their part in reducing a short-term culture in UK companies and markets - the NAPF will endeavour to play its part in achieving this.

2. A regulatory environment which supports longer term risk-taking by pension fund investors

2.1. In recent years pension regulation has driven funds and their sponsors increasingly to take a shorter term view. The NAPF has written at length and commissioned research[1] on IAS 19 which we see 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. In addition, the European

[1] Accounting for pensions, Leeds University Business School, 2011

Commission's moves to introduce a solvency test akin to that applied to insurance companies threatens still further to force more schemes to close to future accruals.

2.2. 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.

2.3. Professor Kay acknowledges the above in his report and rightly states that regulation should focus on the establishment of market structures which provide appropriate incentives. Kay also rightly states that the possible extension of Solvency II principles to pension funds is a matter of particular concern – indeed we believe that the introduction of a Solvency II-style approach to pension scheme funding, represents the single biggest threat to UK defined benefit pension schemes and would equate to a *£291 billion* increase in scheme funding requirements. If sponsoring employers were required to put more funds into their pension schemes, then there would be less money available for investment and innovation, with a concomitant impact on growth.

3. Greater transparency around investment fees and charges

3.1. In our submission to the Kay review we indicated that 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.

3.2. This was an issue which Professor Kay picked up upon in his report and around which there was a particular focus by many last year. Pleasingly there has resultantly been a significant amount of progress. This includes a new joint industry Code of Conduct[2] for disclosing information to employers on the charges made on workplace pensions. This Code should enable, for the first time, the consistent disclosure of charges and investment costs across the workplace pensions landscape.

4. Fostering good practice

4.1. The Government agrees that 'asset holders' have a key role to play in setting the incentives on asset managers, and believes a shift in behaviour in this area will be vital for fostering long-term engagement between asset managers and company directors. To achieve this behavioural change, it was suggested that the Stewardship Code should continue to develop its definition of Stewardship and a number of Good Practice Statements should be adopted by relevant parties.

4.2. Members of the NAPF have a clear interest in promoting the long term success of the companies in which they invest. For this reason we have since its launch in 2010 been a strong supporter of the UK Stewardship Code. We also fully support the recent revisions to the Code which were introduced in September 2012 and which we, like the government, believe have appropriately continued to develop the understanding of 'stewardship'.

4.3. While the Stewardship Code in its first iteration was understandably focused towards asset managers, we are pleased to note that pension funds have themselves been embracing

[2] *Pension Charges Made Clear: A Joint Industry Code of Conduct*

their stewardship responsibilities, the recent revisions to the Code which further clarify the responsibilities of asset owners and managers will further help.

4.4. In December 2012, the NAPF published its eighth annual survey of pension funds' engagement with investee companies[3]. The results from this survey which included members with combined assets under management of £323 billion demonstrated that pension funds are beginning to foster a market for stewardship. The survey indicated that:

- 93% of respondents agreed that institutional investors (including pension funds) have stewardship responsibilities which include engaging with companies and voting.
- 71% of respondents had taken the stewardship activities and policies of asset managers into account when selecting them.
- An overwhelming majority (90%) of respondents had reviewed their asset managers' application of the stewardship policy.
- 93% of respondents had exercised their votes in the UK (up from 90% in 2011) and there was a similar trend in other jurisdictions.

4.5. One of the issues our 2012 Engagement Survey flagged up was that the same level of progress is not necessarily being made by others in the investment chain, particularly among investment consultants.

4.6. Our survey indicated that investment consultants proactively raised the issue of stewardship with pension funds in only two out five cases (38%). In addition, when it was discussed, investment consultants recommended signing up to the Code in less than half of cases. As key intermediaries between pension funds and asset managers, investment consultants could do more to encourage the take-up of the Code by explaining its relevance to their pension fund clients. We believe that this could help drive more pension funds to sign up to the Code.

4.7. As indicated above, since its launch a significant number of pension funds have signed up to the Stewardship Code. However, in light of the recent revisions to the Code and increasing focus on the issue we do believe that the time is right for pension funds to review their approach to Stewardship, question whether it could be more effective and consider how they should undertake their Stewardship requirements.

4.8. For this reason, alongside the Government's response to the Kay Report, the NAPF published its first ever Stewardship Policy[4] which aims to help pension funds understand and fulfil their responsibilities as investors and to become signatories to the Stewardship Code. As the results of our 2012 Engagement Survey demonstrate, many pension funds are already embracing their responsibilities in this area and we are encouraging and assisting others to do likewise.

4.9. We also support the Good Practice Statements proposed by the Kay Review and endorsed by the government. The NAPF Stewardship Policy includes a number of principles for stewardship best practice, closely reflecting the direction set out in this area by Professor

[3] NAPF Engagement Survey: pension funds' engagement with investee companies, 2012
[4] NAPF Stewardship Policy, 2012

Kay in his Good Practice Statements. We will continue assess how else we can support the establishment of the principles contained within these Statements.

4.10. One area which pension funds could perhaps better utilise to reinforce a more long-termist perspective is via their assessments of the sponsor covenant. Within these private exercises trustees could be encouraged to more often consider factors beyond the financials, such as the sponsor company's strategy and governance structures. While funds are encouraged to require their investment managers to take these factors into consideration when assessing investee companies, it is the investment from their sponsor which is perhaps most critical and with whom they have the most intimate relationship.

5. Collaboration amongst institutional investors

5.1. While pension funds have reduced materially their exposure to UK equities in recent years, they remain significant investors in UK the market. However, it is clear that with this trend it is increasingly difficult for companies to easily 'speak' to their shareholders and for shareholders to exert influence over their investee companies.

5.2. On this issue, it is worth reiterating the NAPF's belief in the value of building scale and having fewer, larger schemes. In addition to helping savers secure better retirement outcomes because of the scale and efficiency they would bring, an increase in scale would leverage the voice and thus influence of pension funds in relation to their stewardship of investee companies.

5.3. The NAPF believes that engagement with investee companies is a vital part of the investment management process, however, as we know, pension funds are increasingly delegating their engagement activity to their investment manager. Our Engagement Survey therefore has for the past few years tracked the (perceived) level of collaboration amongst pension funds' fund managers. For each of the past two surveys the response has been the same with 60% of respondents indicating that they are not aware of their fund managers collaborating with other investors on their behalf.

5.4. The recently published NAPF Stewardship Policy also picks up on this theme and states that funds should encourage collaboration between investment managers as a means of more effective engagement and voice. In addition, they should be clear about their managers' approach and should expect a report on such collaboration.

5.5. We are however, very aware that a huge amount of collaboration amongst UK investors does take place, often on an informal basis. Indeed, we ourselves regularly host collaborative engagement meetings for our members with companies. This coordination role is one that is also performed by the ABI and other more informal groups such as the Corporate Governance Forum.

5.6. 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 a 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. The recent announcement from the European Commission that as part of their company law and corporate governance action plan they will seek to increase legal certainty on whether collective engagement on governance matters falls foul of the rules on acting in concert is therefore a very positive one.

5.7. Professor Kay in his report recommends the creation of an Investors Forum to facilitate collective engagement by investors in UK companies. This proposal is one that has prompted a large amount of discussion by those in the industry and more widely.

5.8. As indicated above, we are conscious that a significant amount of collaboration already takes place amongst UK investors, however, as our Engagement Survey indicates, this is not always visible to the end clients, the press or the public. It is vital to keep in mind the necessity for most company engagement to take place in private, if these meetings were to become more public then the quantity and quality of the engagements would suffer.

5.9. That said, we do see merit in considering how investor collaboration can be further supportive and encouraged, especially in light of the broadening spread of a company's investor base to include many more overseas and smaller investors. The NAPF therefore supports the creation of an investors' forum that brings investors together to discuss, in a collaborative way, issues affecting them. It is important however, that any such forum is led by investors for investors.

6. Align directors' pay with long-term performance

6.1. The Kay review called for a revision of executive pay as part of the solution to short-termism in the markets. The Government in its response indicated that it too believes that Professor Kay's prescription for long-term incentives – that these should be in the form of shares to be held beyond the individuals' departure from the company – is an idea which companies should actively consider.

6.2. In recent years the NAPF has emphasised the need for pay restraint, coupled to improved transparency and greater simplicity. We welcome the recent attention on the issue which has helped focus minds on the need for a more fundamental rethink of executive pay structures to ensure much better alignment between rewards to management and the interests of long-term investors such as pension funds.

6.3. In February 2012 the NAPF and Hermes Equity Ownership Services (which undertakes voting and engagement for BTPS and other pension schemes) held an event on executive remuneration which was attended by 44 FTSE 100 companies together with large pension funds both from the UK and overseas including RPMI Railpen and USS Investment Management.

6.4. Our sense from this, and other private and group meetings, is of a growing desire among many companies to re-evaluate current remuneration arrangements and embrace a new approach. We believe there is now an opportunity, which should be seized by companies and investors, to better align pay with the long-term owners of companies.

6.5. We firmly believe that the best form of alignment between executives and shareholders is the ownership of shares over the long-term, with ownership obligations increasing with seniority. The bulk of executives' variable rewards should flow over time from the benefits of being an equity owner. This approach we believe will help position companies for future success – an objective shared by all.

7. Conclusion

7.1. In conclusion, the NAPF is very supportive of attempts to consider the vital issue of how to structure the market such that it incentivises and rewards long-termism.

7.2. Pension funds by their very nature are long-term investors. However, in recent years, as a result of the move by investors around the world to diversify outside their domestic market, the growing maturity of many DB schemes and the effects of pension regulation introduced in recent years, there has been a trend away from UK equities. On the whole though pension funds still remain significant investors in UK the market and 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.

7.3. We believe that what is needed is 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 (via the IORP Directive). In addition the positive trend towards greater transparency around investment fees and charges needs to be maintained.

7.4. Our research indicates that pension funds are embracing their stewardship responsibilities and our recently published NAPF Stewardship Policy explains further how funds should fulfil these responsibilities. However, our Engagement Survey also indicates that others in the investment chain have yet to embrace their responsibilities in this area.

7.5. This point highlights one of the more underwhelming aspects of the Kay report, that being the lack of any firm recommendations to address the issues raised with regards to the length (and cost) of the investment chain. Whilst the positive effort to improve transparency over charges and fees is important more is perhaps needed here.

7.6. 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. As such this places a greater onus on boards to develop a strategy, assess its execution and communicate this ever more effectively to their investors. In hand with this, institutional investors need to continue to develop effective mechanisms through which to collaborate. As such the NAPF will be working with others to assess how Professor Kay's recommendation for an Investors Forum can be practically and effectively progressed.

7.7. Finally, we agree with the logic of the government publishing a progress report, in Summer 2014, to highlight progress across this agenda. This a broad and vital agenda and it is important that momentum is maintained in order that change is achieved.

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