Department for Business, Innovation and Skills - 'Transparency and Trust' discussion paper

NAPF response – September 2013

Introduction

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.

We welcome the opportunity to respond to this discussion paper. Continued efforts to enhance transparency and increase trust in UK business is welcome and should help create a positive environment for investment. We largely restrict our comments to the proposals aimed at the latter of the two objectives of this discussion paper, increasing trust.

The proposals to enhance the transparency of UK company ownership appear largely sensible. We do however; highlight a few issues which the Department should be mindful of when giving further thought to taking them forward. If these concerns are addressed then we believe that the proposed changes would not be expected to impact detrimentally upon our members in any significant way.

On the latter proposals to increase trust in UK businesses, we have strong reservations about the proposal which emanates from the Parliamentary Commission on Banking Standards (PCBS) report to amend directors' duties in the Companies Act for directors of banks. The proposal to create a primary duty to promote financial stability over and above other interests, including shareholders, is mis-directed, sets a worrying precedent and could impact upon the investibility of UK banks. We do however, believe there is merit in considering including this matter more explicitly as one which a director, in all sectors, should have regard to.

We look forward to continuing to engage with the Department as it gives further thought to these proposals over the coming months.

Part A: Enhancing the transparency of UK company ownership

The proposals to enhance the transparency of UK company ownership appear largely sensible; however, others will be better placed to provide an assessment of their practicality on private businesses. .

A central registry of company beneficial ownership information

We agree that there would likely be no added value in additional information being required of and disclosed in a central registry about the beneficial ownership of listed companies, this would simply replicate already currently available information. We also agree that using the current model operational for public companies whereby a company is able to identify parties with an interest in its shares and investors with a 3% interest are required to disclose their position is a sensible approach.

We have concerns however, in relation to the proposed inclusion of Limited Liability Partnerships (LLPs), alongside companies. On the whole, beneficial owners in LLPs do not have voting powers through which to influence the strategy or direction of the LLP and often are not able to 'sell'. Public disclosure of the beneficial owners within a LLP may result in them being the subsequent targets of 'lobbying' from interest groups.

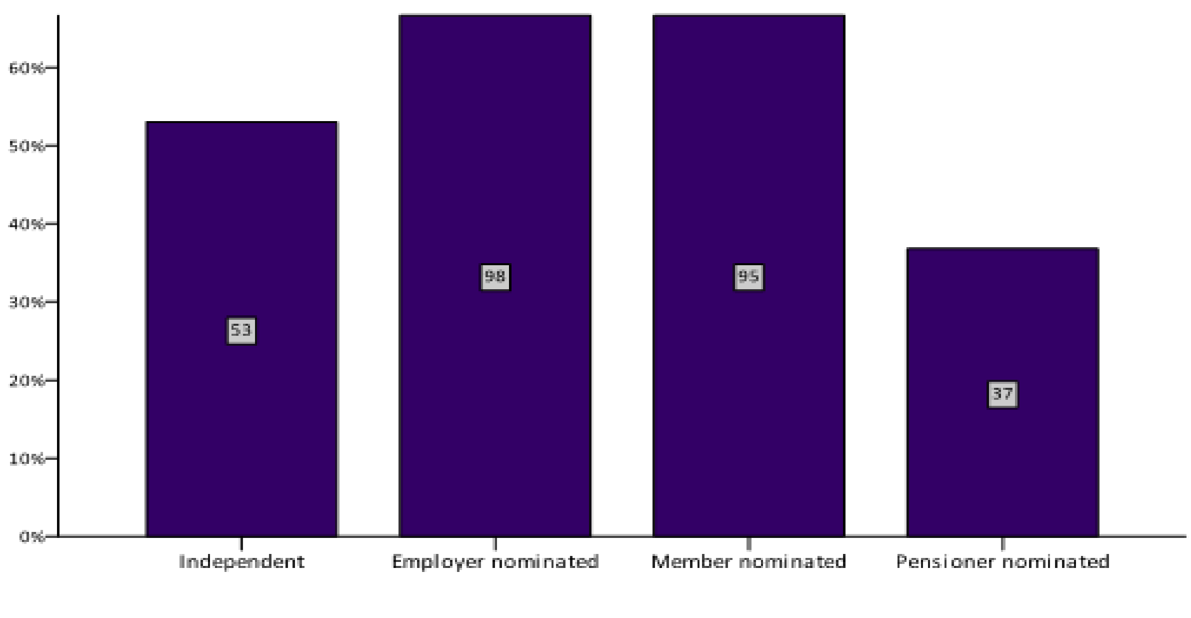
Corporate directors

We understand that the objective of the proposal to prohibit the use of corporate directors on UK company boards is to tackle their potential misuse to conceal beneficial owners and to facilitate illegal activity. However, we have concerns that if this was not carefully worded it could have unintended consequences on pension funds.

Whilst the use of corporate directors in the UK is rightly rare - indeed investors would be expected to take a pretty dim view their use - they are a much more common feature of pension fund trustee boards.

In many cases a pension funds' trustee is a company and it is the board of directors of this company which runs the Fund. Further still, as illustrated below, figures from our 2012 Annual Survey show that just over half (53%) of trust-based pension schemes have an independent trustee on their trustee board of directors. These independent trustees will most commonly be a professional trustee who will in many instances be on the trustee board as a corporate trustee. These corporate trustees have the same responsibilities as an individual trustee in relation to the scheme and play an important role in bringing a great deal of expertise to trustee boards.

Figure A: What type of trustees are members of your trustee board?



Base: 215 respondents.

The current law does recognise that corporate pension scheme trustees are in somewhat of a unique position. We are nervous that a worthwhile objective of prohibiting corporate directorships of UK companies could unintentionally impact upon a parallel desire to ensure that pension schemes have appropriate governance mechanisms in place.

If the above issues are appropriately reflected upon, we would not expect the proposed changes to impact detrimentally upon our members in any significant way and would encourage their progress.

Part B: Increasing trust in UK business

Clarifying the responsibilities of directors in key sectors

We have strong reservations about the proposal which emanates from the Parliamentary Commission on Banking Standards (PCBS) report to amend directors' duties in the Companies Act for directors of banks. The proposal to prioritise the 'safety and soundness' of the firm over the interests of shareholders is we believe mis-directed, sets a worrying precedent and could potentially impact upon the investibility of UK banks.

Since the "crisis" there has rightly been a raft of new banking regulations, domestically and internationally, aimed at strengthening the regulation of the banking sector, ensuring banks are better capitalised, less incentivised to take risk and not such a potential burden on the tax payer. There has also, rightly, been a focus on the role played by shareholders in engaging with companies and exercising their governance responsibilities. This proposal appears to contradict some of these measures taken while adding little value.

We agree that greater independence and professionalism amongst those charged with overseeing banking operations, including, crucially, the non-executive directors is needed. However, we fail to understand how amending the current duties of a bank director as outlined in the Companies Act in the fashion that is proposed will achieve this.

- *Role of shareholders*

We do not believe that the interests of shareholders and the interests of the director are different – both wish to see the company succeed. The interpretation of success and how it can be achieved (while having regard to the impact on employees; the community; the environment and the firms' reputation) will differ from company to company and sector to sector; in the case of banks it could certainly be argued that success is achieved by remaining financially secure and stable. Given that shareholders would be the last class of creditor to receive a distribution in an administration, only receiving a distribution after everyone else has been paid in full; it is very much in their interest that a firm remains financially secure.

The PCBS suggested that it would be a mistake to expect greater empowerment and engagement of shareholders to lead to the exercise of profound and positive influence on the governance of banks. We disagree.

It has been suggested that pre-crisis, banks were seeking to appease shareholder demand for short-term returns. It has also been argued that investors are insufficiently long-term in nature. Importantly however, the current duty of a director is to "promote the success of the company for the benefit of its members as a whole" (while having regard to the likely consequences of any decision in the long term). The language regarding "for the benefit of the members as a whole" establishes that it is by reference to the benefit of the entire body of shareholders taken together that the success of the company should be sought, as opposed to, for example, one particular shareholder or sub-group of shareholders. It is therefore already clear that a director has sufficient legal coverage to be able to push back against any minority shareholders who are pressing their short-term interests ahead of the long-term interests of the firm.

To, as this proposal seeks to do, disenfranchise shareholders as a whole is misguided and at odds with the approach being taken by government and regulators in other areas. For example in relation to the development of the Stewardship Code which has only been in existence since 2010 and is already enhancing

the quality of engagement between companies and investors and other recent reforms which enhance shareholder rights over executive remuneration.

- *Potential impact on bank investibilty*

It should be remembered that it is shareholders who are the providers of risk 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. 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.

At present, the majority of UK banks are failing to achieve a return on equity (ROE) in excess of their cost of equity (COE). If in time banks were able to achieve a sustainable ROE then many of the concerns will fall away. A robust banking sector will have a significant beneficial effect on the broader economy, through enhanced direct lending and income distribution to pension funds and other investors, whilst improving their own capital ratios and loss absorbing capacity. As such if a bank can sustainably deliver an ROE above its COE, investors will be more prepared to invest and recapitalise the bank if and when required.

The mooted change to the directors' duty may well be interpreted in such a fashion that decisions which a board of directors considers are in the best interest of the bank are not taken because they may have an element of risk attached. The potential inhibition of entrepreneurism may in turn impact on a bank's ability to achieve a sustainable ROE.

The ramifications of pursuing short-term profitability, by driving up leverage, remain fresh in many investors' minds from the financial crisis. Consequently, any attempt to 'maximise' ROE in an unsustainable manner, thus creating excessive risk would raise concerns for both investors and no doubt for the regulators too.

- *Safety and soundness - not sector specific and a matter to have regard to*

The Companies Act does not at present distinguish between sectors. We believe that doing so in this instance would establish a worrying precedent. We do not believe that any amendments to directors' duties should be made which are applicable to one sector alone. The concepts of 'safety and soundness' are as relevant to a bank as they are to a retailer or a mining company. While a bank's financial stability may be more systemically important to the economic system as a whole; concerns about this should be addressed through banking specific regulation.

The duty of a director is to act in a way that the director "considers" would be "most likely to" promote the success of the company in doing so they are expected to have regard to a number of factors including the "likely consequences of any decision in the long-term." A fundamental aspect of the "long-term" "success" of a company is of course its ongoing safety and soundness.

The duty is however, at present a subjective test and it is concerned with the success of the company as an aim on the part of the director rather than as a result for the company. While we believe that the current duty requires a director to actively consider the impact on a firm's safety and soundness; there is merit in considering including this matter more explicitly as one which a director, in all sectors, should have regard to. This may provide additional helpful coverage and reassurance to directors who feel pressured to take decisions which may not be in the long-term interests of the bank.

- Re-engage and empower shareholders rather than disenfranchise

Shareholders appoint and rely upon the board of directors to oversee and govern management and to make corporate decisions on their behalf; they do not wish to micro-manage the firms in which they are invested. We encourage the Department to instead of disenfranchising the long-term patient investors that recapitalised the banks and are interested in stewarding stable and successful companies, to continue their efforts to encourage investors exercise their governance responsibilities.

Allowing sectoral regulators to disqualify directors in their sector

At present sectoral regulators do not ban directors in their sectors for breaches of company law, but for sector-specific breaches. While we have some sympathy with the objective we do not believe that an individual should be disqualified from being a director for a breach of a specific regulation in a different sector to which he/she is seeking to be a company director.

We would however, like to see sectoral regulators have the ability to make an application to the Court for a disqualification order. This will allow the Court to make a judgement as to whether the individual who has breached sectoral regulations has also breached the general duties of the Companies Act in such a way as to warrant disqualification from being a director.

In addition, we would like to see significant sanctions from sectoral regulations be included within mandatory disclosure to shareholders. In listed companies, shareholders appoint and re-elect directors annually; given these directors are appointed to manage the company on their behalf, they should be fully informed of the past sanctions or bans a director has been subject to. This information should include a record of any instances in which a director was barred from having a significant influence function in a particular sector or is fully prohibited from working in that sector and any similar sanctions from regulators overseas.

Factors to be taken into account in disqualification proceedings

We believe that courts should be able to take into account all material factors when deliberating over disqualification orders. We agree that it seems reasonable to amend the Company Directors Disqualification Act (CDDA) to provide that further factors may be taken into account by the court in disqualification proceedings; however, prescription of these factors should be avoided and instead courts should be allowed to make appropriate judgements.

- *Sector specific*

The proposal that any breach of sectoral regulations is a matter of unfitness that may be taken into account is perfectly appropriate. While it would be impossible to prescribe which breaches should result in disqualification, taking into account material breaches of relevant sectoral regulation could help give greater insight into an individual’s fitness and determine whether directors should be disqualified or help determine the length of the disqualification period.

- *Wider social impact*

Given the difficulty in defining ‘wider social impact’ we would caution against moves to include this as a matter to be taken into account by the court in disqualification proceedings. It is important that court deliberations are conducted objectively; taking the step to allow the scale of loss suffered by creditors along with and any wider economic or social impact could encourage external pressure to be exerted on courts.

- *A director's previous failures*

There is concern that at present the current regime allows directors to utilise the insolvency process to simply shed debts and start afresh. We do agree that there is merit in considering how best to allow a court to take account of a directors' previous failures, where these are relevant. However, there is also understandable concern with a proposal which may result in early failures following an individual, despite there being no culpability or relevance to the individuals' fitness.

Time limit for disqualification proceedings

At present actions must usually be commenced within two years of the date of the first insolvency event, given that some culpable decisions may take some time to come to light we see merit in extending the time limit for such actions to be brought. We are conscious however, that the extension of the time limit could simply cause further delays to what is already a lengthy process; it is in the interests of the public, directors themselves and shareholders for these proceedings to be initiated and resolved in an efficient manner.

Educating Directors

The proposal to offer director training and to give reduced periods of disqualification to those directors who complete such training has merit. It is important that lessons are learned from failures and in some cases training around accounting and other more technical matters may prove helpful. The proposal that that before making any application to act in the management of a specific company, a disqualified director must show that they have successfully undertaken approved education or training is sensible.

Whilst some may question the expected effectiveness such training; if it was disclosed to shareholders that a director had been through such a programme they would be able to incorporate this into their assessment as to whether the individual in question was an appropriate director for X company.

Extending overseas restrictions

Whilst we would be nervous about a hard and fast rule which prevented persons who are subject to overseas restrictions being able to be directors or act in the management of companies in the UK, we agree that a person subject to foreign restrictions should be obliged to notify the Registrar of Companies. In addition, such information such be considered by the court in any proceedings and be disclosed to shareholders when the individual is seeking appointment to a public company's board.