

# Updating the Myners principles: a consultation

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March 2008



HM TREASURY

**DWP**

Department for  
Work and Pensions

The Pensions  
Regulator 





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# Updating the Myners principles: a consultation

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# EXECUTIVE SUMMARY

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This consultation provides an opportunity to update the Myners principles and develop a comprehensive suite of authoritative best practice tools giving further assistance for pension fund trustees to improve investment decision-making and governance.

The Government welcomes the NAPF's review of the Myners principles and agrees with the review's principal findings and recommendations. The Government proposes to adopt the NAPF's recommended approach subject to some minor changes.

This revised framework will ensure the updated principles are more effective, by being less prescriptive, and more likely to be used and reported against by trustees. A strengthened approach to reporting should also result in more flexible and better quality disclosure and more robust public debate on investment decision-making and governance.

To support this goal, the Government proposes to establish an HMT and DWP sponsored Investment Governance Group under the chairmanship of the Pensions Regulator including industry representatives and trustees, who will co-own the updated principles, monitor their effectiveness, the quality of reporting against them, and make recommendations for improvements to investment decision-making and governance.

The updated principles will provide more flexibility for different types of schemes in terms of their size, financial position and strategy. In particular the updated principles represent a suitable starting point for developing specific frameworks for smaller schemes, defined contribution schemes and Local Government Pension Schemes.

The Investment Governance Group will be best placed to decide where specific issues need to be addressed for such schemes and, where required, to develop bespoke guidance tools and review the effectiveness of the proposed updates set out in this consultation document.



# FOREWORD FROM THE EXCHEQUER SECRETARY TO THE TREASURY AND THE MINISTER FOR PENSIONS REFORM

A well-functioning investment chain is a vital driver of Britain's productivity and long-term sustainable growth. The Government has systematically looked to improve the effectiveness of the investment chain by strengthening corporate governance and increasing the transparency and accountability of companies. The Myners review of institutional investment was a critical step in this process.

That is why we warmly welcome the NAPF's review of the Myners principles six years on. The NAPF's review confirms that the Myners principles are facilitating the spread of best practice among traditional pension schemes, helping to improve trustees' investment decision-making and pension fund governance. Further challenges prevail in continuing progress toward higher trustee skill levels and more effective internal structures and processes.


As the NAPF review suggests, trustees and their advisers need a stronger commitment to better integrate the principles into their governance processes, to provide meaningful 'comply or explain' disclosures, and to monitor and debate the issues this transparency raises. This, we believe, will create the virtuous circle in reporting and action envisaged by Paul Myners.

In turn, more effective trusteeship is likely to enhance the depth and level of shareholder engagement and public disclosure of votes. Supporting this is a growing body of evidence suggesting that focused shareholder engagement can add value.

The Institutional Shareholders' Committee has developed principles to encourage continued improvements in the resourcing and quality of investor engagement ensuring more accountability to owners and creating visibility of conflicts of interest. These initiatives will help institutional shareholders build on the £340 billion of UK equities held by UK institutions on which voting is already disclosed.

We want to take full advantage of the impetus of the NAPF's work to reinforce the Myners principles as the accepted code of best practice in investment decision-making and governance. To make this happen, it is essential that the industry collectively continue to be involved and take responsibility for the content and implementation of these voluntary codes and principles.

As proposed in this consultation, an important step in the right direction will be the establishment of an independent Investment Governance Group to ensure greater ownership of the Myners principles by trustees and the pensions community.



Angela Eagle



Mike O'Brien



# BACKGROUND

**1.1** The Chancellor of the Exchequer asked Paul Myners in March 2000 to examine whether there were distortions in the investment decision-making of institutional investors. Myners' principal conclusion<sup>1</sup> was that many pension fund trustees lacked the investment expertise to act as discerning customers of their investment consultants and fund managers, with consequential effects on their investment decision-making. Resulting problems included: poor evaluation of advisers and advice; reliance by trustees on a small pool of investment consultants, supplying opaquely bundled investment and actuarial advice; limited resourcing of asset allocation decision-making; lack of clarity on investment time horizons in fund management contracts; and insufficient focus on the potential to add value through shareholder engagement.

**1.2** The Government accepted Myners' recommendation that pension fund trustees voluntarily adopt a set of 'comply or explain' principles codifying best practice in investment decision-making. In 2004, the Government reviewed the extent to which the Myners principles had been effective in bringing about change in trustee behaviours<sup>2</sup>. The review found that progress had not reached the expected level in certain areas. These included: trustees' level of skills, expertise and resourcing; performance measurement and reporting; clarity of investment time horizons; shareholder engagement; and clarity of the role and relationships of trustees and investment consultants. In response to the Government's request to undertake a further assessment, the National Association of Pension Funds (NAPF) were tasked with assessing the extent to which, six years on from their publication, pension fund trustees are applying the Myners principles; the extent to which scheme governance and the quality of trusteeship have improved; and whether key issues identified in 2004 have been addressed.

**1.3** Since the Myners principles were first promulgated there have been significant changes in the pensions landscape and the nature of the challenges faced by trustees. For example, in 2001 around half of all schemes were in surplus and by 2007 scheme deficits for FTSE companies stood at £21 billion<sup>3</sup>. Since 2001, defined contribution scheme membership has grown by one-third, with a comparably larger growth in assets<sup>4</sup>. The Government has also taken forward two key Myners review recommendations through legislation. The Pensions Act 2004 abolished the minimum funding requirement replacing it with scheme-specific funding requirements and brought in requirements that pension scheme trustees have sufficient knowledge and understanding of pensions and trust law, principles of funding occupational schemes, investment of scheme assets and making informed decisions. Associated codes of practice<sup>5</sup> from the Pensions Regulator set out practical guidance for trustees on how they can comply with these requirements.

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<sup>1</sup> *Institutional Investment in the UK: A Review*, Paul Myners, March 2001

<sup>2</sup> *Myners principles for institutional investment decision-making: review of progress*, HM Treasury, December 2004

<sup>3</sup> [http://www.watsonwyatt.com/europe/services/retirement/deficit\\_index/default.asp](http://www.watsonwyatt.com/europe/services/retirement/deficit_index/default.asp)

<sup>4</sup> *Institutional Investment in the UK: Six years on*, NAPF, November 2007, p8-9

<sup>5</sup> *Regulatory Code of Practice no. 7: Trustee Knowledge and Understanding (TKU)*, the Pensions Regulator, May 2006

**1.4** The NAPF's report provides evidence that trustees have responded positively to these changes and have made strongest progress in the following areas: improving trustee knowledge and understanding; strategic asset allocation; utilising expert advice; adopting appropriate benchmarks, transparency and reporting and, for larger schemes, activism and engagement. It finds widespread support for the Myners principles as 'accepted wisdom' representing a clear and coherent approach to investment decision-making. The Myners principles are helping the pensions industry respond to the challenges it faces, which consumers, industry and the Government, and particularly pension scheme trustees, stand to benefit from.

**1.5** Nonetheless, while many of the weaknesses identified in 2004 have been addressed, progress has not been even. For some principles and for some types of scheme, progress has been less rapid. For example, while trustees have made significant progress in assessing the performance of their advisers, in particular investment managers, they remain reluctant to assess their own performance. The NAPF also found much lower levels of application of the Myners principles among smaller schemes compared to larger schemes. The reason behind this is clear: by their very nature, small schemes have less access to expert advice and cannot access the efficiencies that come with scale.

**1.6** The NAPF's recommendations set out a framework to address those areas where further progress is needed which is discussed in HM Government's response.

# 2

## HM GOVERNMENT'S RESPONSE

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**2.1** The Government welcomes the NAPF's leadership in taking forward the review of the Myners principles and agrees with the review's principal findings and recommendations. Furthermore, the Government recognises the positive response made by the pensions industry to improve trustee knowledge and understanding which has been aided by the Pensions Regulator's (TPR) work to improve the way pension schemes are governed and the spread of best practice.

**2.2** The Government's goal remains the same as Paul Myners enunciated: the principles should be the accepted code of best practice in investment decision-making and governance, with trustees transparently assessing their capacity and practice against them. Comprehensive best practice guidance and tools need to be provided so that trustees, with appropriate assistance from their advisers, can effectively apply the principles and ensure that standards of investment decision-making and governance continue to rise. The Government believes that the best way to achieve this goal is by working in partnership with industry to continue to develop a set of practical and responsive principles.

**2.3** This consultation provides a timely opportunity to take advantage of the impetus created by the NAPF's review and progress made by trustee boards to reset the balance between, on the one hand, improved higher-level principles and best practice guidance, and on the other hand, a greater emphasis on the quality of 'comply or explain' reporting. Building on the NAPF's recommendations, the Government proposes a framework which involves updating the Myners principles to ensure that they are more effective, by being less prescriptive, and more likely to be used and reported against by trustees.

**2.4** The Government agrees with the NAPF<sup>1</sup> that the Myners principles should be reduced to provide a sharper focus for trustees and their advisers. Consolidating the number of principles will ensure appropriate coverage of the updated principles, building on existing guidance material and increase the effectiveness of the principles to meet the present needs of trustee boards. A focus will be on the continuous improvement of the governance of institutional investments.

**2.5** Furthermore the Government believes that more guidance is needed to provide trustees with details of best practice for implementing the updated principles and ensuring a thorough consideration of the issues relevant to investment decision-making. The Government agrees with the NAPF's recommendations that an updated framework will provide a good place for addressing specifically important technical issues which were previously detailed in the main body of the Myners principles (such as transaction costs).

**2.6** If developed co-operatively, the supporting trustee tools have the potential to become the authoritative source of advice on investment decision-making for trustees. TPR's Trustee Toolkit provides base level learning materials, building on the original Myners principles. There are a number of areas where the Government believes further trustee tools could usefully be added to the NAPF's initial survey and these are given in Annex C.

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<sup>1</sup> *ibid*, NAPF, November 2007, recommendation 2, p43

**2.7** However, decisions on the nature, scope and development of these tools, selecting from current best practice, should ultimately be the responsibility of a joint Government industry Investment Governance Group. The Investment Governance Group will reflect a broad range of industry views and would be chaired by TPR who would also support it. The group will formally co-own the updated principles, monitor their effectiveness, and the quality of reporting against them, and make recommendations for improvements to investment and governance. The group will need to ensure the relevance of the updated principles, providing a reliable basis for further development over time, for example by commissioning a further review on the adoption of the updated principles.

**2.8** There is no 'one size fits all' approach to ensuring better standards of investment decision-making and governance. Moving towards a smaller number of higher-level principles will provide more flexibility for different types of schemes in terms of their size, financial position and strategy to effectively explain their investment decision-making approach to key stakeholders.

# 3

## SCOPE OF THE UPDATED PRINCIPLES

**3.1** The Government does not propose that the updated principles provide a complete blueprint for all aspects of pension fund trustee governance. Rather the scope of the updated principles is limited to governance issues as they apply to investment decisions. As the 2001 Myners review highlighted it is the, “lack of clarity about decision-making structures and incentives (which) causes the misalignment of objectives of the ultimate investors, the millions of consumers and pension fund members, and the agents acting on their behalf”<sup>1</sup>.

**3.2** Part of the aim of moving toward a smaller number of higher-level principles is to provide more flexibility for different types of schemes in terms of their size, financial position and strategy. Because smaller schemes<sup>2</sup> lack the internal and external resources and investment efficiencies that come with scale, they cannot be expected to apply the updated principles in the same way or with the same emphasis as larger schemes. For smaller schemes, the main objective is to help trustees fulfil their legal obligations by achieving an adequate level of knowledge, understanding and competence.<sup>3</sup> Indeed, a process of self-review against the updated principles and the appropriate supporting guidance will help achieve this. In the case of larger schemes, with more complex structures and investment strategies, trustees will face higher expectations and will want to take their capabilities to a higher level.

**3.3** When the Myners principles were originally formulated, the focus was primarily occupational defined benefit (DB) pension schemes. Since then, there have been significant changes particularly with the rise of defined contribution (DC). The original Myners review recommended that investment decisions taken in occupational DC schemes should accord with a set of principles slightly different to those for defined benefit schemes. Many of the proposals set out in this consultation document and the NAPF review will be applicable to DC trust-based schemes not least because some schemes have DB and DC sections and hence the same trustees will be taking decisions on both.

**3.4** The next section sets out proposed amendments to the updated principles as suggested by the NAPF<sup>4</sup>. These aim to ensure that relevant issues are comprehensively reflected and given appropriate priority in each principle and the supporting best practice guidance, to help trustees review their own performance more effectively.

QI: Will the proposed approach (comprising an updated set of principles, best practice guidance, trustee tools, better quality reporting and greater industry ownership of the principles) improve standards of investment decision-making and governance?

<sup>1</sup> *ibid*, HM Treasury 2001, p20

<sup>2</sup> Defined as having less than 500 members, NAPF, November 2007, p35

<sup>3</sup> *Regulatory code of practice no. 7: Trustee knowledge and understanding (TKU)*, TPR, May 2006. TPR’s Trustee Toolkit is a primary source of training to assist trustees in meeting their legal duty to have an adequate level of knowledge and understanding

<sup>4</sup> *ibid*, NAPF 2007, p55-58



# 4

## UPDATED PRINCIPLES AND BEST PRACTICE GUIDANCE

**4.1** The Government agrees with the updated principles as recommended by the NAPF and believes these can be improved by the proposed changes set out in this section. The supporting guidance, produced both by industry and TPR (including TPR’s Trustee Toolkit), provides more detail on best practice and industry standards and measures. Trustees are not expected to report on adoption of each element of best practice guidance in a ‘tick box’ fashion and not all elements will be appropriate for all pension schemes. Trustees can use the guidance to evaluate if they are implementing best practice appropriate to their scheme. Annex C contains the full list of proposed updates to the principles, best practice guidance and trustee tools.

### Principle 1: Effective Decision-Making

**Principle rationale**

**4.2** This principle has the greatest impact on the quality of trustee investment decision-making. It covers critical structural and organisational issues such as the level of trustee knowledge, resourcing, structuring and running the board effectively, and effective management of relations with advisers.

NAPF’s updated principle:	Government’s proposed changes to better reflect the rationale of the principle in red:
<ul style="list-style-type: none"><li>• Decisions should only be taken by persons or organisations with the skills, information, advice and resources necessary to take them effectively and monitor their implementation.</li><li>• Decision makers must have sufficient expertise to be able to evaluate critically the advice they receive.</li></ul>	<ul style="list-style-type: none"><li>• Trustees should ensure that decisions are taken by persons or organisations with the skills, <b>knowledge</b>, advice and resources necessary to take them effectively and monitor their implementation.</li><li>• Trustees should have sufficient expertise to be able to evaluate <b>and challenge</b> the advice they receive, <b>and manage conflicts of interest</b>.</li></ul>

**Best practice guidance outcomes** **4.3** Trustees are responsible for their own internal resources, establishing investment sub-committees, formulating and regularly updating investment business plans and considering trustee remuneration (TPR's Trustee Toolkit provides helpful detail).

NAPF's best practice guidance:	Government's proposed changes to better reflect the best practice guidance outcomes in red:
<ul style="list-style-type: none"> <li>Trustees should ensure they have sufficient internal resource and access external resources.</li> <li>It is good practice for trust boards to have investment sub-committees to provide the appropriate focus and skills on investment decision-making.</li> <li>Trustees should draw up a forward-looking business plan and evaluate its progress.</li> <li>It is good business practice for trustees to be paid</li> </ul>	<ul style="list-style-type: none"> <li>The board has appropriate skills for, and is run in a way that facilitates, effective decision-making.</li> <li>There are sufficient internal resources and access to external resources for trustees and Boards to make effective decisions.</li> <li>There is an investment sub-committee which provides the appropriate focus and skills on investment decision-making.</li> <li>There is an investment business plan and progress is regularly evaluated.</li> <li>Consider remuneration of trustees.</li> <li>Pay particular attention to managing and contracting with external advisers (including advice on strategic asset allocation, investment management and actuarial issues).</li> </ul>

## Principle 2: Clear Objectives

**Principle rationale** **4.4** This principle emphasises the need for trustees to develop clear investment objectives which take into account the strength of the sponsor covenant, the scheme's liabilities and the level of risk tolerance of both the trustee and the sponsor, and members' best interests.

NAPF's updated principle:	Government's proposed changes to better reflect the rationale of the principle in red:
<ul style="list-style-type: none"> <li>Trustees should set out an overall investment objective(s) for the fund that takes account of the scheme's liabilities, the strength of the sponsor covenant as well as the attitude to risk of both the trustees and the scheme sponsor.</li> </ul>	<ul style="list-style-type: none"> <li>Trustees should set out an overall investment objective(s) for the fund that takes account of the scheme's liabilities, the strength of the sponsor covenant as well as the attitude to risk of both the trustees and the sponsor, and clearly communicate these to advisers and investment managers.</li> </ul>

**Best practice guidance outcomes** **4.5** Trustees should develop clear investment objectives which are appropriate for meeting the needs of their scheme. These objectives should reflect members’ expectations, the funding requirements of the scheme, the time horizons over which these must be met, and the capacity of the trustees to make investments of differing complexity (taking into account factors such as scheme maturity and employer affordability). These decisions must be clearly understood in the relationship between the investment manager and the trustees, and reflected in the mandate granted the manager and the timeframe given for its execution.

NAPF’s best practice guidance:	Government’s proposed changes to better reflect the best practice guidance outcomes in red:
<ul style="list-style-type: none"> <li>• It is best practice for trustees to adopt scheme specific benchmarks and objectives, unless there is a clear reason why this is not appropriate.</li> <li>• Trustees should provide their fund managers with clear written mandates including which include clear time horizons for performance measurement and evaluation.</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Benchmarks and objectives are in place for the funding and investment of the scheme.</b></li> <li>• <b>Fund managers have clear written mandates covering scheme and member expectations, which include clear time horizons for performance measurement and evaluation.</b></li> <li>• <b>Trustees consider as appropriate, given the size of fund, a range of asset classes, active or passive management styles and the impact of transaction costs when formulating objectives and mandates.</b></li> <li>• <b>Consider the strength of the sponsor covenant.</b></li> </ul>

### Principle 3: Risks and Liabilities

**Principle rationale** **4.6** This principle requires trustees to consider scheme liabilities when formulating their investment strategy. Trustees have a legal requirement to establish and operate adequate internal controls<sup>1</sup>.

NAPF’s updated principle:	Government’s proposed changes to better reflect the rationale for the principle in red:
<ul style="list-style-type: none"> <li>• In setting their investment strategy, trustees should take account of the risks and form and structure of the liabilities faced by the scheme.</li> <li>• These include the strength of the sponsor covenant, including the risk of sponsor default and longevity risk.</li> </ul>	<ul style="list-style-type: none"> <li>• In setting <b>and reviewing</b> their investment strategy, trustees should <b>take account of the form</b> and structure of liabilities.</li> <li>• These include the strength of the sponsor covenant, the risk of sponsor default and longevity risk.</li> </ul>

<sup>1</sup> The Occupational Pension Schemes (Internal Controls) Regulations 2005, Statutory Instrument No. 3379

**Best practice guidance outcomes** **4.7** Trustees should have a clear policy on their willingness to accept the risk of underperformance due to market conditions, analyse factors affecting long-term performance (such as the impact of interest rates on liabilities) and consider whether their investment strategy is consistent with the scheme sponsor’s objectives and willingness to pay.

NAPF’s best practice guidance:	Government’s proposed changes to better reflect the best practice guidance outcomes in red:
<ul style="list-style-type: none"> <li>Trustees should have a clear policy on their willingness to accept underperformance due to market conditions.</li> <li>Trustees will want to analyse interest rates, inflation and longevity projections and receive advice on how these impact on their scheme and its liabilities.</li> <li>In setting the investment strategy, the trustees will wish to ensure it is consistent with the scheme sponsor’s objectives and ability to pay.</li> </ul>	<ul style="list-style-type: none"> <li>Trustees have a clear policy on willingness to accept underperformance due to market conditions.</li> <li>Trustees take into account the risks associated with their liabilities valuation and management.</li> <li>Trustees analyse factors affecting long-term performance and receive advice on how these impact on the scheme and its liabilities.</li> <li>Trustees have a legal requirement to establish and operate internal controls.</li> <li>Trustees consider whether the investment strategy is consistent with the scheme sponsor’s objectives and ability to pay.</li> </ul>

## Principle 4: Performance Assessment

**Principle rationale** **4.8** This principle covers the need for trustees to monitor investment performance, adviser performance and their own performance.

NAPF’s updated principle:	Government’s proposed changes to better reflect the rationale for the principle in red:
<ul style="list-style-type: none"> <li>Trustees should arrange for the formal and measurement of the performance of the fund, its managers and advisers.</li> <li>Trustees should also periodically make a formal assessment of their own effectiveness as a body and report on this to scheme members in the annual report and accounts.</li> </ul>	<ul style="list-style-type: none"> <li>Trustees should arrange for the formal measurement of the performance of the investments.</li> <li>Trustees should also periodically make a formal policy assessment of their own effectiveness as a decision-making body and report on this to scheme members.</li> </ul>

**Best practice guidance outcomes** **4.9** There should be a formal processes for assessing individual performance of trustees and managers, the chairman taking responsibility for addressing the results of the assessment, and trustees stating how performance evaluations have been conducted.

<b>NAPF’s best practice guidance:</b>	<b>Government’s proposed changes to better reflect the best practice guidance outcomes in red:</b>
<ul style="list-style-type: none"> <li>Trustees should have in place a formal and rigorous policy and process for assessing the performance of individual trustees.</li> <li>Individual performance should show whether each trustee continues to contribute effectively and demonstrate commitment to the role (for example measured by attendance at meetings).</li> <li>The chairman should act on the results of the performance evaluation by recognising the strengths and weaknesses of the Board.</li> <li>Trustees should state in their annual report and accounts how the performance evaluation has been conducted.</li> </ul>	<ul style="list-style-type: none"> <li>There is a formal policy and process for assessing individual performance of trustees <b>and managers</b>.</li> <li>Trustees can demonstrate an effective contribution and commitment to the role (for example measured by <b>participation at meetings</b>).</li> <li>The chairman <b>addresses</b> the results of the performance evaluation.</li> <li>State how performance evaluations have been conducted.</li> <li><b>When selecting external advisers take into account past performance and price.</b></li> </ul>

## Principle 5: Responsible Ownership

**Principle rationale** **4.10** This principle requires trustees to ensure adoption of the Institutional Shareholders’ Committee Statement of Principles on the responsibilities of shareholders and agents, including their schemes policy on responsible ownership in the Statement of Investment Principles, and report to members on the discharge of these responsibilities.

<b>NAPF’s updated principle:</b>	<b>Government’s proposed changes to better reflect the rationale for the principle:</b>
<ul style="list-style-type: none"> <li>Trustees should adopt, or ensure their investment managers adopt, the Institutional Shareholders’ Committee Statement of Principles on the responsibilities of shareholders and agents.</li> <li>A statement of the scheme’s policy on responsible ownership should be included in the Statement of Investment Principles.</li> <li>Trustees should report periodically to members on the discharge of such responsibilities.</li> </ul>	<ul style="list-style-type: none"> <li>The Government proposes no changes to this principle.</li> </ul>

**Best practice guidance outcomes** **4.11** Trustees should disclose their attitude to and policies regarding responsible ownership, ensuring investment managers have an explicit strategy on intervention, consider the potential for engagement to add value and ensure investment consultants adopt the Institutional Shareholders' Committee Statement of Practice relating to consultants.

NAPF's best practice guidance:	Government's proposed changes to better reflect the best practice guidance objectives in red:
<ul style="list-style-type: none"> <li>• It is good practice to disclose to members of the scheme the trustees' attitude to and policies regarding responsible ownership in the annual report and accounts or in the Statement Investment Principles.</li> <li>• Trustees should ensure that managers have an explicit strategy, setting out the circumstances in which they will intervene in a company.</li> <li>• It is good practice for trustees to ensure their investment consultants to adopt the ISC's Statement of Practice relating to consultants.</li> </ul>	<ul style="list-style-type: none"> <li>• Policies regarding responsible ownership are disclosed to scheme members in the annual report and accounts or in the Statement of Investment Principles.</li> <li>• Trustees consider the potential for engagement to add value when formulating investment strategy and selecting investment managers.</li> <li>• Trustees ensure that investment managers have an explicit strategy, setting out the circumstances in which they will intervene in a company.</li> <li>• Trustees ensure that investment consultants adopt the ISC's Statement of Practice relating to consultants.</li> </ul>

## Principle 6: Transparency and Reporting

**Principle rationale** **4.12** This principle requires trustees to be accountable to scheme members. It enjoins trustees to act transparently, communicating periodically with stakeholders on the management of their investments, including performance against objectives, in an appropriate form.

NAPF's updated principle:	Government's proposed changes to better reflect the rationale for the principle in red:
<ul style="list-style-type: none"> <li>• Trustees should act in a transparent manner, communicating with scheme members on issues relating to their management of investments, including performance against stated objectives.</li> <li>• Communication with members should be provided periodically in the form trustees consider most appropriate.</li> </ul>	<ul style="list-style-type: none"> <li>• Trustees should act in a transparent manner, communicating with stakeholders on issues relating to their management of investment, its governance and risks, including performance against stated objectives.</li> <li>• Trustees should provide regular communication to members in the form they consider most appropriate.</li> </ul>

**Best practice guidance outcomes** **4.13** Trustees should ensure that the scheme operates transparently to enhance accountability, and that reporting against best practice provides a basis for a continuing improvement of governance standards.

NAPF’s best practice guidance:	Government’s proposed changes to better reflect the best practice guidance outcomes:
<p>Reporting should:</p> <ul style="list-style-type: none"> <li>• Ensure that the scheme operates transparently and enhance the accountability of trustees to scheme members; and</li> <li>• Ensure that reporting against best practice provides a basis for the continuing improvement of governance standards.</li> </ul>	<p>Reporting ensures that:</p> <ul style="list-style-type: none"> <li>• the scheme operates transparently and enhances accountability to scheme members; and</li> <li>• best practice provides a basis for the continuing improvement of governance standards.</li> </ul>

Q2: Do you agree with:

- The proposed updated principles (as set out in full in Annex C)?
- The proposed best practice supporting guidance (as set out in full in Annex C)?



# 5

## IMPROVING DISCLOSURE

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**5.1** Disclosure is an essential component of a ‘comply or explain’ model. Its purpose is to improve accountability to members encouraging the development and adoption of best practice through public debate between stakeholders. This, coupled with a process of self-assessment against the principles, provides impetus for trustees to continue to improve the quality of their investment decision-making and governance.

**5.2** Hence, Myners’ expectation that trustees would set out annually in their Statement of Investment Principles (SIP) how they were implementing the principles and explaining the reasons for any departures. Compliance with this was patchy in early years but the NAPF’s review finds that levels of member communication have increased significantly and information on compliance is now frequently contained in the SIP and/or financial statements. It has also found near-universal support for the Myners principles of reporting and transparency.

**5.3** The NAPF recommends<sup>1</sup> that voluntarism remain at the heart of the updated principles, reinforced by a strengthened ‘comply or explain’ approach to reporting, in relation to trustees’ disclosure of compliance with the principles. The Government agrees with this recommendation. It sees informative and considered disclosures as essential to the successful operation of a ‘comply or explain’ regime, and the principal reason for not choosing a more prescriptive approach to reporting.

**5.4** The Government expects that a strengthened approach to reporting should result in better quality disclosures and more robust debate, and not in more prescriptive rules or longer ‘boilerplate’ reports. There are a number of elements to this:

- ‘comply or explain’ must be understood as just that. Trustees are not required to comply with the updated principles but the Government endorses compliance as a matter of best practice for all schemes. They are expected to report on how they have applied the updated principles, and, where they have adopted a different approach, explain to the scheme members their justification for doing so;
- as recommended by the NAPF, trustees are expected to report on how they have applied the principles, not how they have applied the supporting best practice or made use of the trustee tools. Best practice guidance is intended to help trustees apply the principles effectively and provide indicators of successful application. Trustees need only report on them where they believe it helps them explain this. Trustee tools provide practical help to trustees seeking to change their practice and processes in line with the intention of the principles;
- the form and content of reporting is not prescribed, trustees should have a free hand to explain their approach to investment decision-making and governance. The Government would like to encourage candid, comprehensive and informative reporting which explains the trustees’ objectives and methods for investment decision-making and governance. Trustees are not encouraged to report on each detail of the updated principles or the supporting best practice for the sake of completeness,

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<sup>1</sup> *ibid*, p41

which can only encourage more use of ‘boilerplate’ compliance statements prepared by scheme investment consultants. If there is a demand for guidance, it should be considered by the proposed Investment Governance Group; and

- the ‘comply or explain’ approach to disclosure is not aimed solely at scheme members. It is also an opportunity for trustees to communicate the extent to which they have fulfilled their stewardship role. Trustees are encouraged to identify areas where either new concerns have arisen or improvements have been made since the last disclosure. Trustees should have discretion in choosing the appropriate means of communicating this information, which may include the annual report and accounts. The nature of disclosure is an area for consideration by the Investment Governance Group, taking into account the objectives of the Government’s forthcoming review of disclosure led by the Department for Work and Pensions (DWP).

Q3: Would pension fund trustees benefit from guidance on the content of reporting against the updated principles?

**5.5** In reporting on the application of the updated principles, trustees need to bear in mind that scheme members will be their major target audience. Member’s best interests will also be better served by good quality public debate. The ‘comply or explain’ model relies on high quality disclosure and thoughtful debate leading to improvements in best practice. The NAPF recommends<sup>2</sup> that trustees ensure that reporting against best practice provides a basis for the continuing improvement of governance standards. The Government agrees and expects trustees, particularly those of larger schemes, to publicly disclose their reporting on application of the updated principles and to participate in the process of improving best practice, whether through participation in the Investment Governance Group or more widely.

**5.6** The NAPF finds that Financial Reporting Council’s Combined Code, is recognised as having effectively driven up governance standards of UK listed companies. The Government agrees that the Combined Code provides a strong template for the application and development of the updated principles. But an important difference should also be noted: scheme members are not the equivalent of institutional investors, and cannot monitor and provide feedback as investors do on the quality of a quoted company’s disclosures. The onus would therefore be on the Investment Governance Group to monitor and provide feedback, on the range and quality of disclosures against the principles. The Investment Governance Group may wish to lead joint industry and Government efforts to improve the quality of transparency and reporting, while mindful of the need not to impose excessive burdens on trustees.

**5.7** The NAPF makes a number of recommendations for the location of reporting<sup>3</sup>. The Government does not wish to prescribe a specific location for trustees’ reporting on application of the updated principles. At the same time, trustees might find useful further guidance on the location of reporting. The Investment Governance Group would be well placed to consider the need for guidance on the location of reporting by trustees in their application of the updated principles.

<sup>2</sup> *ibid*, principle 6

<sup>3</sup> *ibid*, principle 4

Q4: Should the proposed Investment Governance Group consider the need for guidance on the location of reporting by trustees on their application of the principles?



# 6

## OWNERSHIP AND FUTURE DEVELOPMENT OF THE PRINCIPLES

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**6.1** Increasing industry advocacy and promotion of the principles is essential to their continued utility and development. Achieving greater ownership of the principles, by trustees specifically and the pensions community more generally, is a key objective for the Government. This will help improve application of the principles by trustees, encourage better quality reporting against them, and stimulate debate on the development of best practice.

**6.2** The Government agrees with the NAPF's recommendation for greater industry ownership of the principles<sup>1</sup>. The Government wishes to ensure a broad range of industry participation, consistent with effective co-ownership ensuring that the diversity of voices is properly heard. The Government therefore proposes to establish an Investment Governance Group to address those areas identified by the NAPF where improvement in the governance of investment activities is required (for a full list of the Investment Governance Group's proposed Terms of Reference see Annex B). The group would be established under the aegis of TPR, which would chair and support it. Good scheme governance is at the heart of a well-run pension scheme and is the one theme that underpins each of TPR's statutory objectives. This was emphasised in the TPR's medium term strategy which set out an aim for 'year-on-year improvement in the extent to which trustees demonstrate knowledge and understanding of the governance requirements for their schemes'. This includes governance arrangements in respect of investment related activities and given the TPR's knowledge and experience in governance generally, makes it the logical candidate to co-ordinate wide ranging industry input.

**6.3** However, the group should not be perceived as – or become – a Government-run consultative committee. Neither is it a forum for developing regulation or statutory guidance. Co-ownership is distinct from consultation and is essential if trustees and the industry are to make the desired commitment to apply, report on, advocate and promote the principles. All members of the group will be able to bring forward items for consideration and the key objective for the group will be to ensure that the decision-making process is consensual. In circumstances where there is a significant divergence of views it will be the responsibility of TPR in its role as the chair to progress matters which may include consulting with sponsoring Ministers, if necessary.

**6.4** The group's sponsors will be HMT and DWP, reflecting their respective policy responsibilities for the efficiency of the investment chain and the regulation of pensions. Given these interests, the Government proposes that both are represented on the group. The Government also proposes that HMT, DWP and TPR, in conjunction with the industry, will decide the Investment Governance Group's membership. Members will be drawn from representative, professional, and expert bodies with an interest and involvement in the governance of investment-related activities and will include practising trustees.

**6.5** The group will commission and co-ordinate work from its members to meet its objectives, and may establish sub-groups (drawing on the expertise of those outside the Investment Governance Group, if appropriate) and delegate accordingly. The group's role does not constrain the activities that its members take to discharge their own accountabilities. The obligation to apply and report on the updated principles, and to use guidance and trustees tools effectively to fill identified gaps, rests ultimately rest with scheme trustees.

**6.6** The NAPF in its review also recommended that a further, targeted review of the updated principles should be undertaken in three years to ensure continued progress in governance standards and effective investment decision-making. The Government agrees that a further review may be appropriate and considers that the group will be best placed to assess the final scope and timing of the review.

Q5: Should the proposed Investment Governance Group own the updated principles (on the basis set out in Annex B)? If yes, are the proposed Terms of Reference for the Investment Governance Group (in Annex B) the right ones?

**7.1** The Government recognises that for certain schemes there will be specific issues which will need to be addressed and bespoke guidance and tools may need to be developed. The Government believes that the updated principles provide a suitable starting point for developing specific frameworks for DC schemes, small schemes and Local Government Pension Schemes.

### Occupational DC schemes

**7.2** When Paul Myners examined the issue of DC pension schemes they represented a relatively small but fast growing proportion of pension fund assets. He identified several different features of DB schemes with important implications for investment: in particular, that scheme members bear the investment risk and trustees must consequently determine the members' rather than sponsor's attitude to risk. Myners recommended that trustees of DC schemes taking investment decisions on behalf of members apply a set principles tailored to these issues. When selecting investment options, trustees should consider members' preferences and offer a reasonable range of risk and return combinations, trustees should consider the full range of investment opportunities, and where they offer a default option, ensure it has appropriate objectives. Trustees should improve reporting for the benefit of scheme members, particularly to help them make informed investment decisions.

**7.3** As the NAPF review points out, DC scheme membership has grown by one-third since Myners' review, with a comparably larger growth in assets. Trustees of DC schemes have clearly taken steps to apply the Myners principles and in some areas show marginally more positive results than their DB counterparts<sup>1</sup>. Participants to the NAPF review identified the same persistent governance issues as Myners: the default fund, the range of fund choices, and member communication. Views on action ranged widely from making the DC principles the focus of attention, to abandoning DC principles for the FSA's 'treating customers fairly' rules.

**7.4** TPR's April 2007 publication on the governance of work-based pension schemes<sup>2</sup> sets out views on the main priorities of governance for the medium-term. The document highlighted seven governance priorities, including processes for investment choice. Responses from industry<sup>3</sup> were supportive of the recommendations for further guidance and voluntary application of best practice generally. TPR also published its approach to mitigating risks which are specific to DC schemes including those relevant to investment activities, for example, poor investment choices<sup>4</sup>.

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<sup>1</sup> *ibid*, p37

<sup>2</sup> *The governance of work-based pension schemes: discussion paper*, TPR, April 2007

<sup>3</sup> Response to *The governance of work-based pension schemes*, TPR October 2007

<sup>4</sup> *How the Pensions Regulator will regulate defined contribution schemes in relation to risks to members*, TPR April 2007

**7.5** The NAPF recommended<sup>5</sup> that TPR should continue to work with pension schemes, trustees and providers to improve the governance of work-based DC schemes in partnership with industry, including the development of guidance relating to the establishment of voluntary management committees (employer engagement) for contract-based schemes. The work of the Investment Governance Group may therefore include the development and promotion of a refreshed set of principles for DC schemes.

**7.6** The Government agrees with these recommendations. It is appropriate to update the DC principles to reflect the changes which have affected the DB principles and also those market changes affecting solely DC provision. This should be consistent with TPR's other work to improve DC governance in a voluntary framework.

Q6: Should the DC principles be updated by the Investment Governance Group to reflect the changes to DB principles and those market changes affecting DC provision?

## Small schemes

**7.7** The NAPF found a clear correlation between scheme size and compliance with the Myners principles. This is a consistent theme, having been identified in 2004. Small schemes improved their application of the principles and reported similar levels of improvement in knowledge and understanding, and in using more sources of expert advice. They are less likely to report having a good knowledge and understanding of pensions, have an investment sub-committee, consider a wider range of asset classes, include the Institutional Shareholders' Committee statement directly in fund managers' contracts, and to have paid professional independent trustees. This may partly be explained by the fact that small schemes have limited financial resource and independent professional trustees may be unaffordable.

**7.8** Larger schemes have the greater economic impact, accounting for most of the membership and assets in UK pension funds (DB schemes with more than 10,000 members comprise 4% of schemes but 68% of scheme assets). However, even with the continuing growth of DC provision, there are a large number of members of smaller trust-based schemes, whose need for efficient investment and good security is as great as that of the members of large schemes.

**7.9** The NAPF recommends<sup>6</sup> considering tailoring the updated principles for smaller schemes. The Government agrees that small schemes would benefit from assistance in applying the principles. This could take the form of tailored principles or simply guidance on the application of updated principles, supporting best practice and toolkits, and the reporting of application, by smaller schemes. The proposed Investment Governance Group would take this work forward. The Investment Governance Group will also need to consider what is an appropriate cut off point for smaller schemes. A suitable proxy for this may that used by Myners and the NAPF when considering the extent of compliance by size in its review. Schemes with more than 5,000 members can be used as a proxy for large schemes and schemes with less than 500 members as small schemes.

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<sup>5</sup> *ibid*, recommendation 5, p48

<sup>6</sup> *ibid*, recommendation 4, p46

Q7: Should the Investment Governance Group take forward work to help small schemes in their application of the updated principles?

## Local Government Pension Schemes (LGPS)

**7.10** While LGPS schemes operate on similar principles to trust-based schemes, the legal framework differs, reflecting the accountability to local representatives. LGPS funds follow guidance on the Myners principles for local authority schemes prepared by the Chartered Institute of Public Finance and Accounting (CIPFA) and are required to adopt a ‘comply or explain’ approach through their Statement of Investment Principles<sup>7</sup>. HMT is in discussion with Communities and Local Government to ensure that this updated to the principles and the approach is captured in CIPFA guidance, and also to ensure full involvement by the LGPS in the Investment Governance Group process.

**7.11** Given the scope of the principles and the role they play in terms of investment decision-making and governance, there may be a case for their adaptation to the needs of other trust based public sector schemes. This could be a matter for further consideration by the Investment Governance Group.

Q8: Should the proposed updated principles be adopted for LGPS use and LGPS stakeholders be involved in the Investment Governance Group process?

## Responding to this consultation

**7.12** HM Treasury invites comments on this consultation by 23<sup>rd</sup> June 2008. A list of consolidated questions is included in Annex A but respondents are of course free to frame their responses as they see fit.

Please could comments be sent to:

Myners consultation team  
Room 3/20  
HM Treasury  
1 Horse Guards Road  
London, SW1A 2HQ  
Email: Myners.Consultation@hm-treasury.x.gsi.gov.uk

NB: Our preference is to receive responses in electronic format only (all email responses will be acknowledged).

<sup>7</sup> Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998, amended 2002



# 8

## IMPACT ASSESSMENT

Summary: Intervention & Options		
<b>Department /Agency:</b> <b>HMT/DWP/TPR</b>	<b>Title:</b> <b>Impact Assessment of the updated Myners principles of institutional investment</b>	
<b>Stage: Consultation</b>	<b>Version: I</b>	<b>Date: 18<sup>th</sup> March 2008</b>
<b>Related Publications: Institutional Investment in the UK: Six Years on, NAPF, November 2007. Institutional Investment in the UK, a review. HM Treasury, March 2001.</b>		

**Available to view or download at:**

[http://www.hm-treasury.gov.uk/consultations\\_and\\_legislation/consult\\_liveindex.cfm](http://www.hm-treasury.gov.uk/consultations_and_legislation/consult_liveindex.cfm)

Contact for enquiries: Daniel Ingram

Telephone: 0207 270 4725

**What is the problem under consideration? Why is government intervention necessary?**

In 2001 the Myners Review identified a market failure in the institutional investment chain with many pension fund trustees lacking the investment expertise to act as discerning customers of their investment consultants and fund managers. After consultation, the Government issued a set of voluntary principles to improve trustee investment decision-making. It is now preparing to update and simplify these to take into account recent market developments, reducing the cost to trustees.

**What are the policy objectives and the intended effects?**

The Government's goal is to encourage the pensions industry to improve best practice in investment decision-making and governance, with trustees using updated principles as a tool to transparently assess their capacity and practice. The flow through effects of this are to be seen in terms of higher net returns for the beneficiaries of pension funds, a lower cost of funding and management of the risk around funding for firms, and greater efficiency in the allocation of capital, leading to increased productivity in the UK economy.

**What policy options have been considered? Please justify any preferred option.**

- (a) Make no changes
- (b) Issue more detailed principles and guidance requiring more compliance
- (c) Issue a set of simplified principles, best practice guidance and measures to reinforce reporting and public debate over best practice.

Option C is the Government's preferred option. This will reinforce the voluntary 'comply or explain' approach which lies at the heart of the principles. Greater industry ownership will ensure the principles are more likely to be used and reported against.

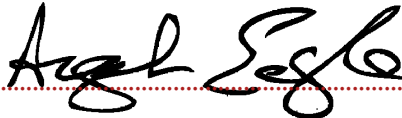
When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects?

The proposed Investment Governance Group would assess the final scope and timing of the progress review.

**Ministerial Sign-off** For SELECT STAGE Impact Assessments:

*I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.*

Signed by the responsible Minister:



..... Date: 18<sup>th</sup> March, 2008.

## Summary: Analysis & Evidence

<b>Policy Option: C</b>	<b>Description: Issue a set of simplified principles, best practice guidance and measures to reinforce reporting and debate over best practice.</b>
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<b>COSTS</b>	<b>ANNUAL COSTS</b>		Description and scale of <b>key monetised costs</b> by 'main affected groups' Investment Governance Group – estimated cost of £85,000–100,000 p.a.
	<b>One-off (Transition)</b>	<b>Yrs</b>	
	£ <b>N/A</b>		
	<b>Average Annual Cost</b> (excluding one-off)		
	£ £85,000–100,000		
<b>Total Cost (PV)</b>			£418, 000
Other <b>key non-monetised costs</b> by 'main affected groups'			

<b>BENEFITS</b>	<b>ANNUAL BENEFITS</b>		Description and scale of <b>key monetised benefits</b> by 'main affected groups' Lower cost of funding and management of risk around funding for firms. Greater efficiency in broader investment chain.
	<b>One-off</b>	<b>Yrs</b>	
	£		
	<b>Average Annual Benefit</b> (excluding one-off)		
	£		
<b>Total Benefit (PV)</b>			
Other <b>key non-monetised benefits</b> by 'main affected groups'			

### Key Assumptions/Sensitivities/Risks

Calculations are highly sensitive to assumptions. Difficulty in establishing causation. Need to take into account substitution effects. Voluntary nature of principles means trustees have incentives to reduce the cost of achieving best practice outcomes.

Price Base Year	Time Period Years	<b>Net Benefit Range (NPV)</b> £ <b>N/A</b>	<b>NET BENEFIT (NPV Best estimate)</b> £ <b>N/A</b>
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What is the geographic coverage of the policy/option?	UK wide
On what date will the policy be implemented?	Autumn 2008
Which organisation(s) will enforce the policy?	HMT/DWP/TPR/industry
What is the total annual cost of enforcement for these organisations?	£ to be confirmed
Does enforcement comply with Hampton principles?	Yes

Will implementation go beyond minimum EU requirements?		N/A		
What is the value of the proposed offsetting measure per year?		£ N/A		
What is the value of changes in greenhouse gas emissions?		£ N/A		
Will the proposal have a significant impact on competition?		No		
Annual cost (£-£) per organisation (excluding one-off)	Micro voluntary	Small voluntary	Medium	Large
Are any of these organisations exempt?	Yes	Yes	N/A	N/A

<b>Impact on Admin Burdens Baseline</b> (2005 Prices)		(Increase - Decrease)	
Increase of	£ N/A	Decrease of	£ N/A
		<b>Net Impact</b>	<b>£ N/A</b>

Key:

Annual costs and benefits: Constant Prices

(Net) Present Value

## Evidence Base (for summary sheets)

### Impact Assessment

#### Proposal

Update the Myners principles for trustees' investment decision-making and pension fund governance and provide best practice guidance and tools to enable trustees to apply the principles more effectively.

#### Objective

Improve trustee investment decision-making and pension fund governance. It is anticipated that the flow through benefits of achieving this will be seen in terms of higher net returns for the beneficiaries of pension funds, a lower cost of funding and management of the risk around funding for firms, and greater efficiency in the broader investment chain.

#### Options

**Option one- Make no changes.** Under this option, the principles would remain unchanged. Although use of the principles by trustees may continue to grow, the principles would not reflect change in best practice or be evenly applied.

**Option two- Issue more detailed guidance and principles requiring more compliance.** Under this option, pension fund trustees would be given more detailed guidance to improve investment decision-making and governance. This option would increase the pressure to undertake the specific measures and would add extra burdens on the industry.

**Option three- Issue a set of simplified principles, best practice guidance and measures to reinforce reporting and debate on best practice.** This is the Government's preferred option. Under this option, a simplified and refreshed set of principles accompanied by a comprehensive suite of authoritative best practice tools will provide trustees with further support to improve investment decision-making and governance. The usefulness of the principles will be enhanced by the establishment of an Investment Governance Group, led by the industry and TPR, which will co-own the updated principles, monitor their effectiveness and the quality of reporting against them, and make recommendations for improvements to investment decision-making and governance.

#### Who is affected

Out of a total of more than 100,000 pension schemes in the UK, an estimated 7,000 occupational pension schemes make investment decisions through trustee boards and therefore fall within the scope of the principles. These schemes tend to be the larger ones. Of the 7,000 schemes, around 500 are classified as very large, because they have more than 5,000 members. Very large schemes

represent around 80% of scheme membership of the pension schemes covered by the principles, and therefore a very substantial proportion of total scheme assets.

The Government believes it is appropriate to use scheme assets as a suitable measure of size, rather than scheme membership. Accordingly, for the purposes of the updated principles, the cut-off for large and complex schemes is proposed to be those with ownership of assets in excess of £250 million. This definition captures a group of funds similar to those defined as very large schemes with more than 5,000 members<sup>1</sup>.

## Costs and benefits

The voluntary nature of the principles affects the regulatory impact assessment. Trustees will only incur the costs of adopting the principles where they are convinced that, on balance, the benefits will exceed the cost (otherwise they would choose to explain their non-compliance). This voluntary mechanism provides an assurance that the value added by the updated principles can be expected to exceed the costs.

Hence, voluntary costs and accruing benefits are not included in the Government's regulatory baseline (nor tabulated in the table at the front of this impact assessment). Nonetheless, in considering the updates to the principles it is important to understand how early adoption of best practice will affect pension funds operations, and these cost and benefit estimates are therefore discussed in the following sections.

The increased flexibility of the updated principles should be taken into account in assessing likely costs. The Government believes that informative and considered disclosures are essential to the successful operation of a 'comply or explain' regime. Trustees are encouraged to draw on a range of sources such as sponsors, in-house staff and a reallocation of existing resources to strengthen scheme reporting. As fund circumstances change, levels of compliance with aspects of the principles are likely to change. This flexibility helps to ensure that the benefits exceed costs over time.

## Costs

Any cost calculation of the proposed changes will be highly sensitive to assumptions. Causation is also important as it is difficult to assess the specific impact of the proposed changes to the principles on investment returns. There are also likely to be substitution effects with some pension funds changing existing practice in compliance, at minimal cost, rather than undertaking additional work effort. This is plausible because the revisions simplify the principles and make them easier to use by developing best practice guidance.

Although there are clearly difficulties in quantifying the cost of implementing the proposed revisions, it is important to provide a reasonable order of magnitude of the range of costs. We would expect the Investment Governance Group to undertake further analysis when filling gaps.

The next section examines the incremental impact of the proposed revisions and finds that very large schemes are likely to incur the majority of costs, in seeking advice on adoption of the principles, the process of implementing the principles and increasing compliance with the principles.

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<sup>1</sup> *Myners principles for institutional investment decision-making: review of progress*, HM Treasury, December 2004.

## Advice on adoption

Trustees of larger and more complex funds may choose to acquire additional professional advice to ensure they effectively adopt the updated principles. After discussions with the industry, we would estimate that very large funds may seek professional advice at around **£2,500 per annum**. We would expect this cost to be incurred for an estimated two years, with implementation of the principles in the first year and a follow-up in the second year, with **an estimated total cost to the very large schemes of around £2.5 million**.

## Process costs

Trustees of larger and more complex funds may choose to devote more time to reporting to scheme members. Reporting higher quality disclosures to members may increase the pressure on existing staff resources and require a re-allocation of labour. Some schemes will choose to allocate more time to reporting than others and costs could be reduced where trustees are more flexible and able to spend more time on higher quality reporting or find alternative lower cost ways of complying. After discussions with industry, we calculate that if all the very large schemes spent more time on higher quality reporting, this could cost around **£5,000-£7,500 p.a.**, with **an estimated total cost to the very large schemes of around £2.5-3.75 million p.a.** This would cost a very large scheme with assets of £750 million around 0.1 basis point.

Trustees should also periodically make a formal assessment of their own effectiveness as a decision-making body. This may increase pressure on existing resources and incur increased incremental cost. Carrying out self-assessment of trustees' performance may require around 2-4 days<sup>2</sup> at around £500 per day, with **an estimated cost to the very large schemes of £0.5-1.0 million p.a.** These would be recurring costs over time.

## Increased compliance

Improving investment decision-making and governance may require increased trustee expertise, for example, to effectively evaluate and challenge advice received. The 2004 Pensions Act requires trustees to have relevant knowledge across their full range of responsibilities so this is not a new cost and, according to the NAPF, trustees have made good progress in improving their knowledge and understanding. It should be recognised that levels of cost will not only vary with the size of the pension scheme, but will also differ depending on the level of expertise that trustees currently possess and, for example, the extent of trustee training.

The Impact Assessment of the Pensions Act assessed that this requirement might result in additional start-up costs per scheme of up to £1,500 per scheme at a total cost of £17 million over a three-year period across all schemes, and thereafter expenditure of **an estimated £9 million p.a.**<sup>3</sup>.

Clearly revisions of the voluntary principles will not have the same impact on very large schemes as legislation. After discussions with industry and depending on how many schemes were encouraged to increase their level of resourcing, there might be **an estimated cost to the very large schemes of between £0- 4.5 million p.a.**

<sup>2</sup> *Institutional Investment in the UK: Six Years On. A Discussion Paper*. January 2007

<sup>3</sup> Based on the following assumptions: investment training costs £500 a day; training in trusteeship costs £500 a day; scheme administration training costs £500 a day; trustees would require one day of training; and only one trustee attends each course per scheme (See Pensions Bill 2004 Regulatory Impact Assessment, House of Lords)

## Investment Governance Group

The Government proposes the establishment of an Investment Governance Group, led by the industry and chaired by the Pensions Regulator, which will co-own the principles, monitor their effectiveness and the quality of reporting against them, and make recommendations for improvements to investment decision-making and governance. Specific details of the membership and process of the Investment Governance Group are still to be determined.

If group members devote an estimated 100 hours of time each (including preparation for meetings) with a cost of around £60- £75 per hour per member, the total cost of member's time will be around £60,000-75,000 p.a. It is estimated that there will be an additional administrative cost to TPR of around £25,000. **The estimated total cost of the Investment Governance Group is £85,000 –100,000 p.a.**

In estimating the net present value (NPV) of the annual cost of the Investment Governance Group, we have assumed that, as proposed in this consultation document, the group will achieve its goal of bringing forward the adoption of best practice over a five year period, and therefore this is the period over which the NPV of regulatory costs is calculated.

## Small firms impact test

We would expect small to medium sized pension schemes to approach implementation of the principles at a higher level than very large schemes and they are not expected to suffer a disproportionate impact from the proposed revisions to the principles. Because these schemes have fewer internal and external resources and investment efficiencies that come with scale, they cannot be expected to apply the principles in the same way or with the same emphasis as larger schemes. Scheme size is therefore relevant in determining the level of effort and resource needed to comply with the principles. For example, proposed changes to improve trustee expertise and better quality reporting to members will tend to apply more specifically to very large pension schemes. Small to medium sized schemes may also choose not to comply with the more detailed or prescriptive aspects of the principles (and explain this to their members) where the benefits would not exceed the costs for them.

The key issue facing trustees of smaller to medium sized schemes is to achieve the basic levels of trustee knowledge, understanding and structure, rather than to develop competencies to the next and higher levels. Priorities include achieving appropriate levels of trustee knowledge and understanding and ensuring they are well organized to make effective decisions, set clear objectives, manage risks and liabilities to protect members, and performance assessment.

There are around 6,500 small to medium sized schemes and after discussions with industry we expect the range of costs which smaller schemes could choose to incur could be around **£1,000-£1,250** for each scheme with a **total estimated cost to small to medium schemes of around £6.5- £8.125 million p.a.** We expect these costs to be ongoing over time.

## Benefits

It is not easy to demonstrate a direct connection between, on the one hand, the impact of the proposed revisions on trustee investment decision-making and governance and on the other, the resulting improvement in investment returns. Proving conclusively that good governance practices leads to better performance is hard because of difficulties in defining and measuring good governance, and in isolating and allowing for the different drivers for performance.

However various studies support the proposition that there are benefits of improved trustee investment decision-making and governance in terms of increased investment returns for the beneficiaries of pension funds<sup>4</sup>. Agents such as fund managers and investee companies have better incentives to perform when there is a sound governance process, whereby investors set clear objectives, insist on transparent reporting, monitor and maintain dialogue with agents, and take steps to ensure that agents are held accountable for performance. Recent research suggests that that the impact of good investment decision-making and governance could be as much as 100-300 basis points per annum<sup>5</sup>. Recent research also suggests that shareholder activism can increase investment returns beyond traditional benchmarks<sup>6</sup>.

At the end of 2006 the value of listed UK equities was £1,858 billion, of which 13% is owned by UK pension funds. If we assume that the benefits of improved investment decision-making and governance are reflected as an increase in returns from listed UK equities, an improvement of 0.125 basis points in the annual rate of return on UK equities would generate £23.2 million p.a in increased returns on equity shareholdings. This **benefit would be more than sufficient to cover the upper range of the costs incurred in adopting the revisions.**

An alternative way of looking at this is that the total value of pension fund assets at the end of 2006 was £989.2 billion. If we assume that all the benefits of improved investment decision-making are reflected as an increase in returns on assets, an improvement of 0.25 basis points<sup>7</sup> in the annual rate of return on pension funds assets would generate £24.73 million p.a in the value of all pension fund assets. This **benefit would be more than sufficient to cover the upper range of the costs incurred in adopting the revisions.**

## Competition

The proposed revisions to the principles are not expected to reduce competition. Occupational pension funds do not directly compete against each other but, to the extent that improved levels of trustee investment decision-making and governance result in better performance, members are likely to see an improvement across the range of pension options.

## Enforcement and sanctions

The principles are voluntary and are based on a 'comply or explain' approach. Under the chairmanship of The Pensions Regulator, and the sponsorship of DWP and HMT, the Investment Governance Group, along with the industry, will co-own the principles and be responsible for monitoring the quality of reporting and the effectiveness of the principles, developing tools for trustees and making recommendations for improvements to investment decision-making and governance.

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<sup>4</sup> For example, *Corporate Governance and Equity Prices*, Gompers, Ishii and Metrick, Quarterly Journal of Economics, February 2003; *Governance and Performance in Corporate Britain*, ABI Research paper, February, 2008

<sup>5</sup> *Best Practice Investment Management: Lessons for Asset Owners from the Oxford-Watson Wyatt Project on Governance*. Gordon Clark and Roger Urwin, 2007

<sup>6</sup> *Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund*. ECGI Finance Working Paper No. 138

<sup>7</sup> 100 basis points= 1%. 1 basis point is therefore 0.01%

### **Monitoring and Review**

To ensure continued progress in governance standards and effective investment decision-making, the Government believes that a further review of the updated principles may be appropriate and considers the Investment Governance Group best placed to assess the final scope and timing of the review.

### **Race, Disability and Gender Equality**

The proposed revisions do not discriminate according to race, disability or gender.

## Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

**Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.**

<b>Type of testing undertaken</b>	<b>Results in Evidence Base?</b>	<b>Results annexed?</b>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	No	No
Sustainable Development	No	No
Carbon Assessment	No	No
Other Environment	No	No
Health Impact Assessment	No	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	No	No
Rural Proofing	No	No



# A

## CONSOLIDATED LIST OF QUESTIONS

Q1: Will the proposed approach (comprising an updated set of principles, best practice guidance, trustee tools, better quality reporting and greater industry ownership of the principles) improve standards of investment decision-making and governance?

Q2: Do you agree with:

- The proposed updated principles (as set out in full in Annex C)?
- The proposed best practice supporting guidance (as set out in full in Annex C)?

Q3: Would pension fund trustees benefit from guidance on the content of reporting against the updated principles?

Q4: Should the proposed Investment Governance Group consider the need for guidance on the location of reporting by trustees on their application of the principles?

Q5: Should the proposed Investment Governance Group own the updated principles (on the basis set out in Annex B)? If yes, are the proposed Terms of Reference for the Investment Governance Group (in Annex B) the right ones?

Q6: Should the DC principles be updated by the Investment Governance Group to reflect the changes to DB principles and those market changes affecting DC provision?

Q7: Should the Investment Governance Group take forward work to help small schemes in their application of the updated principles?

Q8: Should the proposed updated principles be adopted for LGPS use and LGPS stakeholders be involved in the Investment Governance Group process?



# B

## PROPOSED APPROACH FOR THE INVESTMENT GOVERNANCE GROUP

**B.1** In response to the NAPF's recommendation<sup>1</sup>, the Government proposes to establish an Investment Governance Group which would be chaired by the Pensions Regulator (TPR), who would also provide support to the group. The group would address those areas identified by the NAPF where improvement in the governance of institutional investment activities is required. HMT and DWP, the group's sponsors, and TPR will decide the membership and terms of reference for the group, in conjunction with the industry. Members would be drawn from representative, professional, and expert bodies with an interest and involvement in the governance of investment-related activities and include practicing trustees.

**B.2** The group will commission and co-ordinate work from its members to meet its objectives, and may establish sub-groups and delegate accordingly. The group's role does not constrain the activities that its members take to discharge their own accountabilities. The obligation to apply and report on the updated principles, and to use guidance and trustee tools effectively to fill identified gaps, rests ultimately with scheme trustees. The group should not be perceived as – or become – a Government-run consultative committee. All members of the group will be able to bring forward items for consideration and the key objective for the group will be to ensure that the decision-making process is consensual. To ensure continued progress in effective investment decision-making and governance standards, the Government believes that a further review of the updated principles may be appropriate and considers that the group will be best placed to assess the final scope and timing of the review.

The Government suggests the following Terms of Reference for the Investment Governance Group:

- promote best practice in investment-related governance by occupational pension schemes including defined benefit, defined contribution schemes, small schemes and local government pension schemes;
- encourage and influence improvements in standards of investment-related governance and sharing of good industry practice;
- take ownership of the principles for institutional investment decision-making, monitor their application and reporting by trustees and recommend improvements as required;
- identify and direct users to existing best practice guidance and trustee tools that support the principles and co-ordinate action by group members to fill any gaps, including the provision of further tools to assist trustees within a voluntary 'comply or explain' environment; and
- from time to time, advise the group's sponsors on the state of investment-related governance.

<sup>1</sup> *ibid*, p48





# TABLE OF UPDATED PRINCIPLES, BEST PRACTICE GUIDANCE AND TOOLS

Principle	Best practice guidance	Trustee Tools
<p>The high level principles will be the accepted code of best practice throughout the industry in investment decision-making and governance. It is expected that trust boards will report against these on a voluntary 'comply or explain' basis.</p>	<p>Best practice guidance is intended to help trustees to apply the principles effectively. Trustees are not expected to implement every element of best practice. Rather trustees may use best practice examples where appropriate to help demonstrate whether compliance has been achieved.</p>	<p>Tools provide practical help and support to trustees and their advisers to enable them to apply the principles and ensure that standards of investment decision-making and governance continue to rise.</p>
<p><b>Principle 1: Effective decision-making</b></p> <ul style="list-style-type: none"> <li>Trustees should ensure that decisions are taken by persons or organisations with the skills, knowledge, advice and resources necessary to take them effectively and monitor their implementation.</li> <li>Trustees should have sufficient expertise to be able to evaluate and challenge the advice they receive, and manage conflicts of interest.</li> </ul>	<ul style="list-style-type: none"> <li>The board has appropriate skills for, and is run in a way that facilitates, effective decision-making.</li> <li>There are sufficient internal resources and access to external resources for trustees and Boards to make effective decisions.</li> <li>There is an investment sub-committee which provides the appropriate focus and skills on investment decision-making.</li> <li>There is an investment business plan and progress is regularly evaluated.</li> <li>Consider remuneration of trustees.</li> <li>Pay particular attention to managing and contracting with external advisers (including advice on strategic asset allocation, investment management and actuarial issues).</li> </ul>	<ul style="list-style-type: none"> <li>TPR's Trustee Toolkit and other training material</li> <li>Publication of best practice guidance/templates e.g. in relation to business plans, scheme structures etc.</li> <li>TPR guidance on conflicts of interest</li> <li>Publication of industry-average lay- trustee remuneration.</li> </ul>
<p><b>Principle 2: Clear objectives</b></p> <ul style="list-style-type: none"> <li>Trustees should set out an overall investment objective(s) for the fund that takes account of the scheme's liabilities, the strength of the sponsor covenant and the attitude to risk of both the trustees and the sponsor, and clearly communicate these to advisers and investment managers.</li> </ul>	<ul style="list-style-type: none"> <li>Benchmarks and objectives are in place for the funding and investment of the scheme.</li> <li>Fund managers have clear written mandates covering scheme and member expectations, which include clear time horizons for performance measurement and evaluation.</li> <li>Trustees consider as appropriate, given the size of fund, a range of asset classes, active or passive management styles and the impact of transaction costs when formulating objectives and mandates.</li> <li>Consider the strength of the sponsor covenant.</li> </ul>	<ul style="list-style-type: none"> <li>TPR guide on covenant assessment</li> <li>TPR Trustee Toolkit</li> <li>IMA Pension Fund Disclosure Code</li> <li>Marathon Club Guidance for Long-Term Investing</li> </ul>
<p><b>Principle 3: Risk and liabilities</b></p> <ul style="list-style-type: none"> <li>In setting and reviewing their investment strategy, trustees should take account of the form and structure of liabilities.</li> <li>These include the strength of the sponsor covenant, the risk of sponsor default and longevity risk.</li> </ul>	<ul style="list-style-type: none"> <li>Trustees have a clear policy on willingness to accept underperformance due to market conditions.</li> <li>Trustees take into account the risks associated with their liabilities valuation and management.</li> <li>Trustees analyse factors affecting long-term performance and receive advice on how these impact on the scheme and its liabilities.</li> <li>Trustees have a legal requirement to establish and operate internal controls.</li> <li>Trustees consider whether the investment strategy is consistent with the scheme sponsor's objectives and ability to pay.</li> </ul>	<ul style="list-style-type: none"> <li>TPR guide on working with the employer and on scheme investments.</li> <li>Code of practice No 3 on Funding Defined Benefits.</li> <li>Code of practice No 9 on Internal Controls</li> <li>TPR guidance on longevity</li> </ul>

<p><b>Principle 4: Performance assessment</b></p> <ul style="list-style-type: none"> <li>Trustees should arrange for the formal measurement of the performance of the investments.</li> <li>Trustees should also periodically make a formal policy assessment of their own effectiveness as a decision-making body and report on this to scheme members.</li> </ul>	<ul style="list-style-type: none"> <li>There is a formal policy and process for assessing individual performance of trustees and managers.</li> <li>Trustees can demonstrate an effective contribution and commitment to the role (for example measured by participation at meetings).</li> <li>The chairman addresses the results of the performance evaluation.</li> <li>State how performance evaluations have been conducted.</li> <li>When selecting external advisers take into account past performance and price.</li> </ul>	<ul style="list-style-type: none"> <li>Trustee 'Key Performance Indicators'</li> <li>TPR's Trustee Toolkit</li> <li>Assessing consultants performance 'toolkit' e.g. model balanced scorecard etc.</li> </ul>
<p><b>Principle 5: Responsible ownership</b></p> <ul style="list-style-type: none"> <li>Trustees should adopt, or ensure their investment managers adopt, the Institutional Shareholders' Committee Statement of Principles on the responsibilities of shareholders and agents.</li> <li>A statement of the scheme's policy on responsible ownership should be included in the Statement of Investment Principles.</li> <li>Trustees should report periodically to members on the discharge of such responsibilities.</li> </ul>	<ul style="list-style-type: none"> <li>Policies regarding responsible ownership are disclosed to scheme members in the annual report and accounts or in the Statement of Investment Principles.</li> <li>Trustees consider the potential for engagement to add value when formulating investment strategy and selecting investment managers.</li> <li>Trustees ensure that investment managers have an explicit strategy, setting out the circumstances in which they will intervene in a company.</li> <li>Trustees ensure that investment consultants adopt the ISC's Statement of Practice relating to consultants.</li> </ul>	<ul style="list-style-type: none"> <li>Statement of Investment Principles</li> <li>ISC Statement of Principles</li> <li>Supporting statement for investment consultants on the ISC principles</li> </ul>
<p><b>Principle 6: Transparency and reporting</b></p> <ul style="list-style-type: none"> <li>Trustees should act in a transparent manner, communicating with stakeholders on issues relating to their management of investment, its governance and risks, including performance against stated objectives.</li> <li>Trustees should provide regular communication to members in the form they consider most appropriate.</li> </ul>	<ul style="list-style-type: none"> <li>Reporting ensures that: <ul style="list-style-type: none"> <li>the scheme operates transparently and enhances accountability to scheme members; and</li> <li>best practice provides a basis for the continuing improvement of governance standards.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>Statement of Investment Principles including statement of funding principle</li> <li>Websites/helplines (for larger schemes)</li> <li>Annual report and accounts</li> <li>Best practice on quality disclosure and reporting</li> </ul>







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