

NAPF response to the Walker Review

Introduction

The National Association of Pension Funds (NAPF) represents 1200 workplace pension schemes in the UK and 40 businesses providing valuable services to those schemes. Together our members own around £80bn of assets and provide benefits to over 10mn people.

For many years the NAPF has both directly and through its members made a material contribution to the development of corporate governance policies in the UK. High standards of corporate governance are important to pension funds not only because they underpin long term success at the companies in which they invest but also because a strong sponsoring company is essential to the health of defined benefit schemes which continue to provide pensions for a significant part of the UK workforce. Pension schemes are also major consumers of a wide range of financial services and thus have also a direct interest in the development of a strong industry with improved standards of transparency and accountability.

We therefore welcome this Review and its extension to include the wider financial services industry.

The NAPF is one of the participating organisations on the Institutional Shareholder Affairs Committee (ISC). In our comments below we have not repeated the recommendations of the ISC, except where we wish to place particular emphasis on specific issues which are of concern to our members.

Overview

In the near-twenty years since Sir Adrian Cadbury first set out his corporate governance principles for the UK's listed companies, we have seen a gradual refinement to those principles, in response to market developments, to the point where the Combined Code is widely regarded as providing a sound basis for the development of good corporate governance practices in the UK and elsewhere. Many of its principles have also found their way into recommended governance practices for pension funds. We see the Code as having two great strengths: it does not seek to lay down detailed rules; and it is flexible in its application, through the comply or explain mechanism.

While the past few months have raised legitimate questions about the governance of some banks, we do not think that this should be taken to imply that the Code is seriously flawed or that there is a need for the introduction of additional regulations. We also note that the majority of UK listed companies have weathered the current

storms successfully and with little evidence of material shortcomings in their governance practices, so far. Our submission to the FRC reflects this view in its recommendation of a few changes to the Code, mainly around the role of the chairman and the non-executive directors, remuneration and the responsibilities of shareholders.

The role of the board and in particular the chairman and CEO in setting tone of the business cannot be over-emphasised. A strong lead in defining objectives and business practices does affect behaviours through the company. Changes to the Code should be designed to support those aspects of their roles and their accountability to shareholders.

It is important when considering the role of institutional shareholders in monitoring their investments, that the limitations to their capabilities are recognised. UK pension funds, for example, own 13% of the UK market and therefore represent at best a significant, but declining, minority interest. Their managers are mandated with delivering a return on investment in shares and bonds out of which pensions are to be paid and, if an active manager, to sell shares where the expectation is that a sufficient return will not be generated. Larger pension funds have been leaders in engagement with companies and more are now adding such a requirement to their mandates. However investment managers are not expected to micro-manage a business and are not "insiders". Boards oversee the management of the business on behalf of shareholders and will be judged on the success of the strategy as it evolves.

Turning to the financial services industry, we believe that it needs to address more effectively the conflicts of interest inherent in a business model which often combines services to clients (some of them fiduciary) with trading activities. Within the former there are also conflicts (for example in asset management, between asset gathering and delivering strong investment performance). Improved disclosure to shareholders, the board and clients, of the conflicts and how they are addressed is desirable. Pension funds can play their part in improving accountability by being more demanding of their service providers (consultants, investment managers, custodians) when carrying out periodic appraisals of their services.

The effectiveness of risk management at board level

Banks have developed sophisticated risk management systems which until recently were seen as capable of addressing the increasing complexity of their business. Boards and management are now assessing what changes are needed in order to ensure that they are more effective going forward. From the shareholder perspective we can contribute little to that internal discussion, but we would expect the regulator to take considerable interest in improving risk management and its monitoring by senior management. It has been suggested that the function needs to be integral to business decisions, while reporting outside the business. This implies weaknesses in current structures which need to be addressed.

Of more interest to shareholders is the oversight of higher level, strategic risks, which include the range of businesses, the structure of the balance sheet and acquisition policies. Weaknesses in this oversight, which is clearly a board responsibility, arguably contributed more to our current problems than poor risk management systems. We note the very full description of risk management provided, for example, by Barclays this year but also note that its focus is on processes more than outcomes.

We have little to add to the discussion on remuneration and risk. The two clearly have to be linked, but the precise mechanism will vary depending on the different lines of business. The board remuneration committee should take risk into account when determining its policy and should explain to shareholders how the two are related.

The balance of the board

Any complex business requires a mix of complementary skills on its board. An examination of UK bank boards suggests that, on the surface, they have that mix. What is much less clear is whether the non-executive directors have the tools to interrogate management effectively and whether board agendas are sufficiently focussed on the right strategic issues to allow directors to perform their stewardship role properly.

We suggest:

- that the company secretary function is strengthened to ensure that NEDs have access to more resources.
- that when a director is proposed for re-election his skills and contribution to the board are set out in detail to enable shareholders to make an informed judgement.
- that complex financial groups might also benefit from appointing outsiders to the boards of key subsidiaries.

The effectiveness of board practices

Shareholders will assess the effectiveness of board practices based on the successful delivery of the stated strategy of the organisation. Where that has been found wanting they will question the roles of the board committees and indeed the whole board and will seek changes to its composition and practices. However, this analysis is by definition retrospective. Boards should demonstrate to shareholders that they have in place an effective evaluation process, making use of external advice as appropriate.

Pension funds, as clients of financial services firms, are concerned with service delivery standards, be they fund administration or investment advice. Trustee boards, particularly among the larger schemes, are increasingly conducting evaluations of their own effectiveness and that of their service providers.

The role of institutional shareholders

The NAPF supports the comments and recommendations of the recently-published ISC paper. We would emphasise the limitations of engagement while at the same time acknowledging that investors could be more effective.

A useful distinction can be made between more routine engagement which tends to be related to compliance with the Combined Code and engagement relating to a company's strategy. The processes for addressing the former are well developed and reasonably effective as most larger investors have a dedicated resource committed to it and there is good support from organisations such as the NAPF. However, engagement on strategic issues would benefit from more collaboration among major shareholders. We recognise that this is difficult to achieve: institutional investors are competing for business; investors may not always agree on the problem or its solution. That said, the NAPF along with the other members of the ISC, is committed to the development of a mechanism which will facilitate such engagement.

Pension funds can support better engagement by incorporating the ISC's Statement of Principles into their Statement of Investment Principles (SIP) and holding their managers to account for applying them.

Engagement is not however a one way street. Companies and in particular their chairmen need to ensure that they have communicated their business strategy clearly to shareholders and that they have understood and addressed any reservations which they may have. Because investors have different objectives it is difficult to get clarity around what is expected of a business. Companies should be more willing to ask their larger shareholders why they own the shares.

The UK approach vs international practice

High level principles of corporate governance have been developed, and are widely used, by the OECD, UNPRI and the ICGN. These are regularly updated and form a suitable base from which countries can build local best practice. Attempts at constructing more detailed guidelines have tended to founder in the shorter term on legal issues. However we note the gradual convergence of best practices (eg the "say on pay" trend in the US).