FairPensions™
The campaign for **responsible** investment

Fairshare Educational Foundation
Trowbray House
108 Weston Street
London SE1 3QB
020 7403 7800
fairpensions.org.uk

Treasury Select Committee Inquiry into corporate governance and remuneration: Written Evidence from FairPensions

Summary

- Good corporate governance in financial institutions should promote sustainable wealth creation and effective management of risks, including systemic risks.
- Regulation and good corporate governance are complementary; comply or explain is effective if explanations are meaningful and properly scrutinised. There is now some recognition of a need for improvement in this respect.
- The Stewardship Code has been effective in gathering mainstream industry support for the concept of stewardship, but less so in translating this into meaningful behavioural change. This should be addressed, including through this year's review of the Code.
- Many of the key barriers to greater shareholder engagement can be traced to principal/agent problems in the investment chain. The challenge lies not just in encouraging greater engagement but in ensuring alignment of incentives between companies, investment intermediaries and savers so that this engagement promotes long-term value creation rather than short-term return-chasing. Evidence suggests that this challenge has not yet been met. Key barriers include:
    - Narrow interpretations of institutional investors' fiduciary duties to savers, which (a) assume that fiduciaries cannot have regard to anything which is not immediately monetisable, and (b) encourage fiduciaries to 'follow the herd'. FairPensions has proposed statutory clarification to create a more flexible and enabling environment in which a broader approach can be taken to beneficiaries' best interests, including their interest in management of systemic risks.
    - Conflicts of interest among fund managers. Conflicts management needs improvement, including through greater oversight either from institutional clients or from regulators.
    - Lack of consumer demand due to the disconnect between 'ultimate owners' and the stewardship debate. Greater transparency and accountability to beneficiaries could help to generate market pressures for better shareholder oversight.
- Disclosure of remuneration in financial institutions should include not just the quantum of pay but also the performance criteria on which variable pay is based. Without this it is difficult to see how shareholders can assess whether incentives are appropriate.

About FairPensions

1. FairPensions is a registered charity that works to promote active share-ownership by institutional investors in the interests of their beneficiaries and of society as a whole. Our particular focus is on encouraging shareholder engagement with listed companies to ensure effective management of environmental, social and corporate governance (ESG) risks which may affect long-term financial returns. We work collaboratively with investors

on issues where there is a strong business case for engagement. We also educate and facilitate individual pension savers to take an interest in their money, and advocate for greater transparency and accountability to beneficiaries about how shareholder rights are exercised on their behalf.

2. We are a member organisation. Our members include bodies representing pension savers, leading UK charities and thousands of individual pension fund members. We are independent of industry and are funded primarily by grants from charitable foundations and trusts.

Regulation, governance and 'comply or explain'

3. Good corporate governance in financial services should seek to promote:
- sustainable wealth creation (this may not coincide with the maximisation of short-run returns, as the 2008 crisis all too clearly demonstrated); and
- effective management of risk, including potential systemic risks posed by the institution's activities.

4. Both of these objectives serve the long-term interests of shareholders whilst also protecting the public interest in stable and sustainable financial institutions.

5. We regard regulation and good corporate governance as complementary. The 2008 crisis exposed failings in both regulation and corporate governance as mechanisms for ensuring that financial institutions pursued sustainable business models and managed risks effectively. Regulation should set the parameters of acceptable behaviour (external accountability), while good corporate governance should ensure effective strategic decision-making and risk management within those parameters (internal accountability).

6. 'Comply or explain' is only as good as the quality of explanations offered for non-compliance by boards, and the degree of critical scrutiny of those explanations by shareholders. Evidence suggests there is much room for improvement in this respect. A 2005 study by the London School of Economics found that firms who did not comply with the Combined Code of Corporate Governance *"often did a very poor job explaining themselves"*, with almost one in five cases of non-compliance not explaining themselves at all. Moreover, the study concluded that *"shareholders seem to be indifferent to the quality of explanations"*.[1]

7. Our recent research suggests this conclusion may still hold. The Stewardship Code suggests that asset managers should disclose their approach to company 'explanations' for non-compliance with the Corporate Governance Code. When we surveyed UK asset managers' disclosures under the Stewardship Code, this was a particular area of weakness. For instance, one firm simply stated "*We evaluate each deviation on its own merits"* without giving any insight into the criteria on which explanations were judged. Such detail was a feature of the better statements we examined, but unfortunately these were the exception rather than the rule.[2] The recent attention given to the quality of explanations by the FRC and industry participants is welcome. This issue should continue to be monitored closely.

---

1 Arcot, Bruno & Grimaud, 2005, 'Corporate Governance in the UK: Is the comply-or-explain approach working?'

2 FairPensions, 2010, 'Stewardship in the Spotlight', p9, http://www.fairpensions.org.uk/sites/default/files/uploaded_files/whatwedo/StewardshipintheSpotlightReport.pdf

Impact of previous reviews and regulatory developments

EU regulatory engagement

8. Given the internationalisation of both ownership and company operations, as well as the systemic risks to the international economy posed by poor corporate governance of financial institutions, there is some justification for discussions about corporate governance taking place at European and international levels. For instance, a proliferation of national Stewardship Codes modelled on the UK Code would be costly and confusing both for companies with international ownership and for investors with international equities portfolios. The idea of a pan-European Stewardship Code may therefore have some merit.

Impacts of the Walker Review

9. Though we engaged with many aspects of the Walker Review, our expertise on what has happened since relates primarily to the introduction of the Stewardship Code. This has certainly had an impact in promoting the *concept* of stewardship (virtually the entire UK asset management industry, by assets under management, has signed up to the Code). What is less clear is its impact on the quality of stewardship in *practice*.

10. Examples such as the blocking of Prudential's planned takeover of the Asian arm of AIG in 2010, or the recent wave of rebellions over executive pay, might suggest a step up in shareholder oversight. However, the general picture is much more mixed. In the recent FT/ICSA Business Bellwether survey, 79% of responding FTSE 350 companies reported no increase in engagement since the introduction of the Code, with the remaining 21% reporting only a slight increase.[3] Similarly, the FRC's first review of the Code found that most companies "*[had] noticed relatively little change in approach to engagement*".[4]

11. Our own research[5] suggests that the decision to keep the Code high-level and principles-based has not prevented a 'tick-box' approach to disclosures, with many asset managers simply repeating the wording of the Code's Principles. This was particularly the case regarding management of conflicts of interest. Disclosure of voting records under Principle 6 of the Code also remains poor. One study by PIRC found that just 15% of signatories disclose full records, and two-thirds do not disclose at all.[6]

12. The FRC's success in gathering signatories to the Code must now be built on with efforts to raise standards of behaviour and disclosure. This year's review of the Code offers one opportunity for this.

Non-Executive Directors

13. Our submission to the FRC's review of the then Combined Code suggested that the Code should recommend that a full-time executive director should (by definition) not hold any other directorships, unless this was approved by the shareholders of all the companies concerned. We are still of the view that the Corporate Governance Code should be amended to this effect.

---

3 See http://www.ft.com/cms/s/0/9ec5594c-6f8f-11e1-b368-00144feab49a.html

4 FRC, December 2011, 'Developments in Corporate Governance 2011: The impact and implementation of the UK Corporate Governance and Stewardship Codes'. Available at http://www.frc.org.uk/images/uploaded/documents/Developments%20in%20Corporate%20Governance%2020116.pdf

5 See footnote 2

6 See http://www.pirc.co.uk/news/vote-disclosure-and-stewardship

The role of shareholders

14. There is now general consensus that managing the principal/agent problems associated with the shareholder/manager relationship requires active shareholder oversight. However, to achieve this there is a need to disaggregate what we mean by the term 'shareholder'. The investment chain itself is made up of a series of principal/agent relationships, the most important being that between asset managers and asset owners (such as pension funds), and that between asset owners and ultimate beneficiaries (such as individual pension savers). This 'triple agency problem' is the source of many of the key barriers to better shareholder oversight of systemically important financial institutions. Some of the specific issues we identify below are currently being considered by Professor Kay's Review of UK Equity Markets.

Short-termism & misaligned incentives

15. It is important to note that 'absentee landlords' were not the only problem in the run-up to the 2008 crisis. Shareholder demands were an active driver of greater leverage and more risky strategies in the pursuit of short-term returns. Only one major asset manager (The Co-operative Asset Management) voted against RBS' takeover of ABN-AMRO, with only one other (Royal London) abstaining.

16. This chimes with a more general picture of shareholder pressure towards short-term results which emerges from surveys both of directors and of investors themselves. In one US study, 78% of financial executives interviewed said they would give up long-term economic value to maintain smooth earnings flows to their investors in the short-term.[7] In the recent FRC review of the Stewardship Code, many companies felt that "*some shareholders still seemed to focus too much on specific issues of a short-term nature*".[8] In a survey of ten large European pension funds, their ideal time horizon was estimated at 23 years and their actual time horizon at six years. Participants blamed short-term, benchmark-relative remuneration structures for the discrepancy.[9]

17. There is clearly a misalignment between the inherently long-term financial interests of pension savers and the short-term metrics used both by pension funds to assess fund manager performance, and by fund managers to assess company performance. It is unclear that the post-crisis focus on stewardship has done anything to alleviate this problem – and equally unclear that current norms of shareholder oversight would be effective in preventing a repeat of the 2008 crisis.

Narrow interpretations of fiduciary duty

18. FairPensions' research[10] suggests that one reason for this misalignment may be unduly narrow interpretations of institutional investors' legal duties. Pension fund trustees have a fiduciary duty to act in the best interests of their beneficiaries. However, this is widely interpreted as a duty to maximise short-term returns and ignore other considerations, even if they might have a material impact on long-term outcomes for beneficiaries. This is a real barrier to stewardship: legal advice given to one large UK pension scheme even suggested that their policy of exercising voting rights could breach their fiduciary duties if they could not demonstrate that the costs incurred were justified by monetisable benefits

7 Graham et al, 2005, 'The Economic Implications of Corporate Financial Reporting', http://papers.ssrn.com/sol3/papers.cfm?abstract_id=491627

8 See footnote 4

9 Hesse, 2008, 'Long-term and sustainable pension investments: A study of leading European pension funds' . See http://bit.ly/uaPQdd

10 FairPensions, 2011, 'Protecting our Best Interests: Rediscovering Fiduciary Obligation'; FairPensions, 2012, 'The Enlightened Shareholder: Clarifying investors' fiduciary duties'. http://www.fairpensions.org.uk/fiduciaryduty

to that individual scheme. Since the benefits of stewardship almost inevitably accrue to the market as a whole, this contributes to a 'free-rider' problem.

19. Institutional investors' fiduciary duty to invest prudently has also been interpreted by UK and US courts as being relative to the behaviour of other investors.[11] This encourages herding behaviour, sometimes characterised as 'reckless caution', and potentially exacerbates systemic risk. For instance, we have been told privately that, before the dot-com bubble burst, some managers who recognised the bubble and avoided tech stocks were sacked by pension fund clients for underperforming their peers in the short-term.

20. In combination, these widely held perceptions of the law contribute to a focus on chasing alpha (outperformance) rather than improving the quality of beta (market performance) through stewardship activities. This is one driver of the 'short-term, benchmark-relative remuneration structures' which incentivise fund managers to demand that their investee companies prioritise short-term returns. It also has no place for the wider interest of pension fund beneficiaries in the management of systemic risk: events like the 2008 crisis affect outcomes for pension savers far more than the degree to which their individual fund outperforms the market, yet current interpretations of the law require their agents to relentlessly prioritise the latter.

21. FairPensions has proposed statutory clarification to remove these perceived legal barriers to better shareholder oversight. The aim would be to create a more flexible and enabling environment by clarifying that fiduciary investors *may* consider factors beyond quarterly results, and to encourage a focus on sustainable wealth creation. We have published draft legislation which suggests, among other things, that investors should be explicitly permitted to have regard to “*the impact of [their] investment activities on the financial system and the economy*”.[12] This is intended to help resolve the problems outlined above, and should create space for better shareholder oversight of systemically important financial institutions.

Conflicts of interest

22. One less frequently invoked aspect of fiduciary duty is the duty to avoid conflicts of interest. There is considerable anecdotal evidence that conflicts of interest among fund managers are one barrier to more robust shareholder engagement. For example, one recent paper cites an instance where “*the company secretary of a UK manufacturer reminded a fund manager who was intending to vote against the company’s remuneration report that his firm was bidding for an investment mandate from the corporation’s pension plan”.*[13] In financial conglomerates, conflicts may arise between asset management arms and investment banking arms. When we surveyed asset managers' disclosures under the Stewardship Code, we found that many gave little or no insight into how these conflicts were managed. The FRC has also identified this as an area for improvement. Asset owners should be more attentive to how conflicts are managed by their investment agents; greater clarity is also needed about asset managers' own fiduciary responsibilities. As the Law Commission has concluded, asset management is *prima facie* a fiduciary function,[14] but this does not appear to be widely accepted or applied within the industry.

Transparency and market pressures

11 See FairPensions, 2012, 'The Enlightened Shareholder', p7-8

12 Ibid, Appendix A

13 Wong, S., ‘How conflicts of interest thwart institutional investor stewardship’, Butterworths Journal of International Banking and Financial Law, Sept 2011.

14 Law Commission, 1992, ‘Consultation Paper No. 124: Fiduciary Duties and Regulatory Rules’ (HMSO), para 2.47

23. An analysis of the chain of principal/agent relationships between saver and company also highlights the absence of market pressures from those whose money is ultimately at stake. Beneficiaries have been virtually absent from the stewardship debate: indeed, there is often some intellectual confusion about whether investors' 'stewardship responsibilities' are owed to companies or to savers (in law, it is clearly the latter). Most savers are disconnected from decisions made about their money and many do not even realise that it is being invested in stocks and shares.

24. FairPensions works to change this through consumer engagement – the most recent example being our online tool enabling individual savers to contact their pension fund or stocks-and-shares ISA provider asking about their voting intentions on remuneration. We believe that greater transparency to these 'ultimate owners' could ensure that demand for stewardship is transmitted along the chain. If the Stewardship Code continues to produce poor levels of voting disclosure (see paragraph 11), consideration should be given to the exercise of reserve powers in the Companies Act 2006 to make disclosure mandatory.

Remuneration

25. In our submission to the Treasury's recent consultation on bank executive remuneration disclosure, we supported the extension of disclosure to significant risk-taking decision-makers below board level. However, we were concerned that the government's proposed requirements related only to the quantum of remuneration, and did not cover the performance criteria on which variable components were based. It is difficult to see how this meets the government's stated objective of addressing the problem of "*poorly designed remuneration structures [which incentivise] excessive risk taking*",[15] since it does not provide information about the behaviours which remuneration is incentivising or disincentivising.

26. We also suggested that a disconnect exists between the role HM Treasury appears to envisage for institutional investors in making use of remuneration disclosures, and the way in which shareholders view their own responsibilities. The key objective of the reforms appears to be to facilitate oversight of systemically important actors. Institutional investors such as pension funds tend to be 'universal owners' (i.e. they have holdings across the economy), and therefore do have an interest in the long-term stability and sustainability of the economy as a whole, which may not coincide with their interest in maximising short-term profits at individual firms (see paragraph 20). In practice however, shareholders appear to evaluate executive pay precisely in the context of the recent performance of the individual firm in question. HM Treasury should work with the FRC in developing the UK Stewardship Code to ensure that it meets this challenge head-on, by encouraging institutional investors who are 'universal owners' to engage with systemically important companies in this spirit.

---

15 HMT, 2011, Bank Executive Remuneration Disclosure: Consultation on Draft Regulations, p5