Myners principles for institutional investment decision-making:

review of progress

December 2004

HM TREASURY

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PREFACE

This consultation document sets out the results of the Government's review of the extent to which the Myners principles have been effective in bringing about behavioural change. It seeks views on:

- the proposed revisions to the Myners principles;
- the proposal for pension funds with more than 5,000 members to provide a 'FRAG-style' independently-compiled review of their implementation of the Myners principles;
- ways in which the Government can work with the industry to strengthen the skills and expertise of the trustee pool;
- the Government's initial Regulatory Impact Assessment (RIA) of the proposed revisions to the Myners principles; and
- any other matters arising from the review.

The Government's proposed revisions to the Myners principles are set out in Annex A.

An initial RIA is set out in Annex B.

The Government would be grateful for any comments on the above points to be sent by 16 March 2005 to the following address:

Myners principles: review of progress
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Please ensure that all responses provide details of the organisation the views of which are represented.

Unless respondents indicate otherwise, it will be assumed that they have no objection to their response being made public.

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EXECUTIVE SUMMARY

In March 2000, the Chancellor of the Exchequer commissioned Paul Myners to conduct a review of institutional investment in the UK. The review was asked to consider whether there were distortions in institutions' investment decision-making. The efficiency of investment decision-making is an important driver of productivity, helping ensure that capital is allocated effectively and that managers are monitored and held accountable for performance.

One of Myners' main conclusions was that many pension fund trustees lack the necessary investment expertise to act as strong and discerning customers of the investment consultants and fund managers who sell them services. Problems that have resulted include:

- poor evaluation of advisers and their advice;
- a reliance by trustees on a small number of investment consultants, supplying actuarial and investment advice bundled together;
- insufficient resources devoted to the process of asset allocation, relative to its impact on total fund returns;
- unclear contractual structures which generate strong and unnecessary incentives for herding and short-termism in investment; and
- insufficient focus on the potential for adding value through active shareholder engagement.

In order to address the distortions Myners identified, he recommended that pension fund trustees voluntarily adopt, on a 'comply or explain' basis, a series of principles codifying best practice for decision-making in relation to investment. These principles would be a powerful force for behavioural change. The central tenets included:

- decisions should be taken only by those with the right skills and expertise, and trustee boards should ensure they have access to appropriate skills and resources;
- fund managers should be set clear objectives and timescales;
- the performance of all advisers and managers should be measured, and trustees should assess their own performance;
- trustees should engage with investee companies where it is in the interests of their fund members so to do; and
- the investment strategy and returns of the fund should be reported annually to members and the public, as part of a strengthened Statement of Investment Principles (SIP).

The Government agreed that the principles represent a clear and coherent approach, which will help the pensions industry respond to the challenges it faces, and from which everyone – consumers, industry and Government, but especially pension funds themselves – stands to benefit. The Government committed to reviewing after two years the extent to which the principles had been effective in bringing about behavioural change. This paper reports the results of that review.

The evidence on change

The review has been based on a substantial body of evidence collected through:

- a structured qualitative study of 14 pension schemes (published in November 2003);
- a quantitative survey of trustees representing 1,580 occupational schemes (published in July 2004);
- a survey of 89 local authority pension schemes; and
- extensive consultation with industry and other stakeholders.

The evidence – presented in more detail in chapter two – shows that action is certainly being taken on a voluntary basis by many schemes. Over half of all trustees surveyed agreed that the principles provided guidelines for best practice, and had encouraged formalisation of previously ad hoc behaviour, leading to trustees being better informed, and addressing issues they would not otherwise have considered.

Schemes representing a majority of occupational scheme members have taken formal decisions to act – in some way and to some extent, not necessarily resulting in full implementation – on six of the ten key issues covered by the principles. Larger schemes (those with more than 1,000 members) which represent more than 90% of total scheme membership, are, understandably, significantly more likely than smaller schemes to have taken action on the issues arising from the principles. Local authority schemes are also among those to have made the most progress.

Around 70% of schemes reported that they were fully, or mostly, compliant with the principles in aggregate. However, this self-assessment of overall progress may be in itself a matter of concern, as it does not appear to be borne out by the progress which the survey indicated had been made against each principle individually. And 18% of all schemes took no action on the principles during the two years following their publication.

The review identified a number of important areas where progress is lagging, and where pension funds are therefore not yet likely to be serving their members' and sponsors' interests as well as they might:

- many trustee boards have not yet attained the levels of skill, expertise and resourcing necessary to achieve the improvements in investment decision-making envisaged by Myners. This overarching deficit is a contributor to the other areas of poor progress;
- a continuing lack of clarity of the respective roles of trustees and their advisers;
- insufficient resources being devoted to the asset allocation process, relative to its impact on total fund returns;
- a continuing mismatch in perception between trustees and fund managers over the investment time horizons managers are working to;
- insufficient promotion of shareholder engagement;
- poor quality of commentary on, and disclosure of, progress in implementing the principles.

Paragraphs 2.11 - 2.22 give more detail.

Making further progress: next steps

The Government has concluded that the voluntary approach is beginning to work, but considerably more efforts are needed to ensure that problem areas identified by the review – and set out above – are satisfactorily addressed. It believes that pension funds would better serve their members' and sponsors' interests if the best practice embodied in the Myners principles were to be strengthened and amplified, particularly in relation to trustee expertise and the process of investment decision-making. Chapter three provides more details of these changes, and of other specific actions which are for the industry to take forward.

Improving trustee expertise and the process of investment decision-making

Strengthening trustee skills and expertise is fundamental to achieving Myners' goal. The new Pensions Act will require all trustees to have appropriate knowledge and understanding of funding, investment, and relevant legal and scheme-specific issues. The new Pensions Regulator will be responsible for enforcing this legal requirement, and the Occupational Pensions Regulatory Authority (OPRA) is currently developing a detailed code of practice to provide trustees with guidance.

The Government proposes that the Myners principle in relation to effective decision-making (principle 1) should be strengthened to align it with the objective standard of expertise set in the new Pensions Act; but also to incorporate the review's conclusion that: the role played by the chair of the trustee board; having a critical mass of trustees with investment expertise; and the availability of additional resources to support the trustee board, are all key factors in promoting effective investment decision-making by pension funds. It therefore proposes to add three new elements to the principle.

In all pension funds, the chair has a critical role in ensuring that the board as a whole has appropriate skills to address its responsibilities, and sets aside the appropriate time and resources to address investment decision-making. Thus the principle will now state that:

- the chair of the board should be responsible for ensuring that trustees taking investment decisions are familiar with investment issues and that the board has sufficient trustees for that purpose.

In addition, reflecting the critical mass of assets managed by the very largest schemes, and the vital importance therefore of their investment decision-making, the principle should also state that:

- funds with more than 5,000 members should have access to in-house investment expertise equivalent at least to one full-time staff member who is familiar with investment issues;

- for funds with more than 5,000 members, the chair of the board and at least one-third of trustees should be familiar with investment issues (even where investment decisions have been delegated to an investment subcommittee). In this context, familiarity with investment issues means being sufficiently expert to be able to take investment decisions, rather than delegate them.

The Government recognises that it will take time to develop and recruit a qualified and appropriately skilled pool of trustees. The Government wants to work with the industry to strengthen the trustee pool and is open to proposals that would help achieve this important goal effectively. It would particularly welcome views on this issue in responses to the consultation.

Ensuring more effective use is made of advisers

Improvement in expertise and decision-making processes should help transform trustee boards into more informed and effective customers for advice, reducing trustees' over-dependence on investment consultants in the relationship. More expert boards should also be more pro-active in assessing the performance of their advisors. The Government looks to the NAPF's review of guidance for contracting with investment consultants to help develop better measurement tools and processes in this context. Further analysis of the investment consultancy market will be provided by Sir Derek Morris's wide-ranging review of the actuarial profession (actuarial services are often bought as a 'bundle' with investment consultancy). In addition, the FSA is planning to restrict the scope of 'soft' and 'bundled' commission, and is working with fund management and broking firms to develop a rigorous transparency regime for disclosure of transaction costs.

Improving the resourcing and quality of asset allocation activity

Despite evidence that asset allocation explains most of the variation in pension fund returns, Myners found that pension funds were putting less resource into this activity than its impact on final returns warranted. The research provides little evidence that trustees are generally devoting greater resources and attention to asset allocation. The changes described above to strengthen expertise and decision-making processes, and for larger schemes to have in-house resource equivalent at least to one full-time staff member familiar with investment issues, should help.

The Government further proposes:

- to amend the principle on expert advice (principle 4) so that contracts for investment advice should be split between advice on strategic asset allocation and advice on fund manager selection. This should encourage greater competition and diversity of experience in the market for asset allocation advice by, for example, drawing fund managers in to tender for these contracts.

Getting greater clarity on investment time horizons

This is primarily an issue of reducing the mismatch in perceptions between fund managers and trustees over the length of performance time horizons. The Government proposes to clarify and simplify the relevant element of principle 5 (explicit mandates) to state that:

- trustees should agree mandates containing clear timescale(s) for performance measurement and evaluation.

This increases the onus on the industry to deliver change. The Government continues to challenge the industry – investment consultants especially – to devise and actively promote more effective contractual structures between trustees and fund managers. It notes in particular the concrete steps by the industry – in the form of the 'Marathon Club' of senior institutional investors – to look for practical ways to reduce the barriers to the establishment of long-term mandates with fund managers.

Getting more effective shareholder engagement

The Myners report recommended that the Government should legislate for shareholder engagement. Following discussions with the Institutional Shareholders Committee (ISC), the Government agreed to the ISC's proposal to pursue this recommendation, initially voluntarily, through a set of ISC principles for engagement, and to assess progress after two years. The Government believes that effective engagement requires informed consideration and judgement, and cannot be achieved by a 'box ticking' approach based on mere formal compliance. The industry needs to ensure that the ISC principles have been integrated into investment decision-making and asset management processes, and that the quantity and quality of resources and people committed to engagement, and the level of qualitative reporting provided by fund managers, are appropriate. The Government is awaiting the results of the ISC's review of progress before reaching its own assessment of the extent to which these principles have been successful in achieving this behavioural change.

To remove ambiguity and make clear the responsibility of trustees for ensuring appropriate engagement is undertaken, the Government proposes to revise principle 6 (activism) to replace the reference to the US Labor Department Interpretative Bulletin with an analogous requirement to comply with the ISC principles. The proposed revised principle would state:

- Trustees should comply with the Institutional Shareholders Committee statement of principles on the responsibilities of institutional shareholders and agents, and ensure that the principles are incorporated into fund managers' mandates. In line with the principles, trustees should also ensure that managers have an explicit strategy, elucidating the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy.

Improving the quality of commentary and disclosure

The original Myners review argued that a good practice model, backed up with disclosure on a 'comply-or-explain' basis, can be a powerful force for behavioural change. It therefore proposed that pension funds should set out annually in their SIP how they are implementing the principles and explain the reasons why they have decided to depart from any of them. The expectation was that this would provide an informed commentary, in which trustees explained and justified their approach, and lead over time to the establishment of benchmarks of good practice, and their dissemination across funds.

Disclosure to date has been patchy and, moreover, in general, been less rich and informative than envisaged by the original review. In part, this may reflect the relatively weak collective pressure which fund members are able to bring to bear on trustees. There are signs that other external pressures to act on the Myners principles are growing. (Some credit rating agencies, for example, now offer scheme assessments which can provide a more comprehensive view of a scheme's key financial and other parameters, and the Trades Union Congress (TUC) is raising awareness of, and providing implementation guidance on, the Myners principles through its network of more than 1,000 trustees.) Over time, partly in response to such pressures, commentary and disclosure is likely to improve. But the Government considers that there would be benefits – to pension funds and their members, as well as more widely – in making progress more quickly.

The Government has decided not to <u>require</u> schemes to disclose their compliance with the Myners principles in their SIP. Monitoring such a requirement could be costly and time-consuming, and might result simply in uninformative 'box ticking' activity. Instead, it sees merit in a voluntary, independently-compiled report on implementation of the principles by trustees, akin to the FRAG reports commissioned by custodians to demonstrate to clients their compliance with various internal control procedures. This would be more flexible than mandatory disclosure and the reports would contribute to an informed commentary on the quality of compliance, helping establish benchmarks of good practice, providing information to members and other stakeholders, and helping trustees validate their decision-making procedures more effectively.

The Government therefore proposes to:

- establish a working group, chaired by the Treasury, with the NAPF and other stakeholders to develop further the practicalities of a 'FRAG-style' report on implementation of the principles.

The Government also proposes to improve the quality and availability of information provided to members and stakeholders by amending principle 10 (regular reporting) to state additionally that:

- trustees should make available assessments of their own performance to the scheme membership; and
- trustees should post on a fund website the key information they provide annually to fund members. For funds with more than 5,000 members, it is good practice to have a website dedicated to the fund.

Cost impact

The initial Regulatory Impact Assessment (RIA) in Annex B suggests that the costs of these proposals are unlikely to be large. Pension funds already incur large costs, not all of which – as Myners' original report showed – are subject to effective scrutiny as a result of the weakness of many trustees as customers. Such costs also need to be seen in the context of the very considerable potential gains for members and sponsors from improved investment performance.

Consultation on proposed changes

The draft revised Myners principles, incorporating the various changes described above, are attached at Annex A. The Government is now consulting on the proposed changes to the Myners principles, and welcomes comments on these and on any other aspects of its proposals by 16 March 2005. It calls on the industry to rise to the challenge of delivering on the measures needed to achieve Myners' vision of better investment decision-making, for the benefit of pension funds themselves, and the wider economy. The NAPF has agreed to undertake a further review in 2007 of the progress its members are continuing to make against the Myners principles, and put the results to Government. In light of the NAPF's evidence, the Government will assess the degree to which the principles have resulted in behavioural change and consider whether there still remains a need for further policy action, by the end of 2007.

1 INTRODUCTION

Background

1.1 In March 2000, the Chancellor of the Exchequer commissioned Paul Myners to conduct a review of institutional investment in the UK. The review was asked to consider whether there were distortions in institutions' investment decision-making. Myners concluded that there were a number of areas where change would result in improved investment decision-making. In his report[1], which was published in March 2001, he recommended that pension fund trustees voluntarily adopt, on a 'comply or explain' basis, a series of principles codifying best practice for decision-making in relation to investment.

1.2 The Government accepted Myners' recommendation, as well as his further recommendation that it should review after two years the extent to which the principles have been effective in bringing about behavioural change. This paper reports the results of that review.

Importance of the investment chain

1.3 UK institutional investors manage almost half of UK equities, investing much of the long-term wealth of British savers and exercising indirect control and significant influence over much of British industry. But this ownership is intermediated through an 'investment chain' of relationships connecting ultimate owners with their investment in companies. Ensuring this chain works efficiently is of vital economic importance for productivity and long-term growth because the chain is a critical mechanism for ensuring that investment is efficiently allocated.

1.4 The chain is complex: in pensions, for example, pension fund trustees, stewards on behalf of pension fund sponsors and members, are themselves advised by investment consultants; assets are in turn invested through fund managers and brokers with whom companies have crucial relationships; and companies' financial statements are verified by auditors acting on behalf of shareholders – such as pension funds.

1.5 Since the 1998 Pre-Budget Report, the Government has systematically investigated how well the investment chain works, notably through the Myners, Sandler[2] and Higgs[3] reviews. These reviews have identified critical and inter-connected areas where the chain has not been functioning as well as it should, including its various principal-agent relationships. Further analysis of the investment consultancy market will be provided by Sir Derek Morris's wide-ranging review of the actuarial profession, which provides key advisory services to pension funds and investment institutions; and Paul Myners will shortly be concluding his review of the governance of mutual life insurance offices.

1.6 The complex interactions between the problems at different points in the chain mean that each needs to be addressed if the overall goal of promoting more efficient approaches to investment is to be realised. In response to this analysis and the recommendations made by the reviewers, the Government has undertaken a

[1] *Institutional investment in the United Kingdom: a review,* Paul Myners, March 2001

[2] *Medium and long-term retail savings in the UK: a review*, Ron Sandler, July 2003

[3] *Review of the role and effectiveness of non-executive directors,* Derek Higgs, January 2003

comprehensive programme of reform, one intended to take account of and reinforce the workings of financial markets.

1.7 The Myners principles represent part of this response. Another key element is the revised Combined Code on Corporate Governance, which incorporates Sir Derek Higgs's recommendations on strengthening the role and independence of non-executive directors and their responsiveness to shareholders. The Government has additionally strongly promoted more active engagement on the part of shareholders in exercising their rights particularly where they have concerns about management, strategy or performance. A number of further reforms, notably the Directors' Remuneration Report Regulations, proposals for an Operating and Financial Review, and improvements in financial reporting and in the quality and independence of audit, are either in place or being implemented, and will contribute to much improved information flows through the investment chain.

1.8 The 2004 Pre-Budget Review sets out in more detail the Government's analysis of the investment chain and the measures it has taken and is taking to improve its efficiency[4].

Myners' analysis

1.9 Myners examined the efficiency of the investment decision-making of occupational pension funds. Pension fund trustees are at the heart of the system. But Myners found that:

- trustees are often asked to take crucial investment decisions without either appropriate resources or expertise to make informed judgements;
- as a consequence, trustees rely heavily on a small number of investment consulting firms, whose advice and performance they are not sufficiently expert to examine critically, or evaluate;
- trustees also commit a low level of resources to asset allocation decisions and advice. The lack of attention these decisions receive is likely to affect investment performance;
- the objectives set for fund managers are often unrelated to the long-term objectives of the pension fund. Fund managers are often assessed against the performance of a 'peer group': this encourages managers to herd around a benchmark and undermines active fund management;
- there is also a lack of clarity about the timescales over which fund managers' performance is to be judged. This uncertainty leads to an unnecessary emphasis being placed on achieving short-term results;
- fund managers appear unnecessarily reluctant to engage with companies in relation to corporate underperformance, despite the possible benefits this might have for their clients. Trustees also do not generally mandate such engagement;
- the substantial costs of broking commissions are subject to insufficiently clear scrutiny and control.

[4] *Opportunity for all: The strength to take the long-term decisions for Britain*, Pre-Budget Report, December 2004, paragraphs 3.112 - 3.117

1.10 These problems are complex, and essentially to do with incentives and behaviour. To tackle them, Myners drew up a comprehensive set of principles of best investment practice for the trustees of occupational pension schemes (the 'Myners principles'[5]). He recommended that compliance with the principles should be voluntary[6], but that pension funds should disclose to their members either their compliance or an explanation of their reasons for departure. The expectation was that this would provide an informed commentary, in which trustees explained and justified their approach, and lead over time to the establishment of benchmarks of good practice, and their dissemination across funds. The voluntary approach would give pension funds the flexibility to adapt their responses to their specific circumstances and avoid the risk of unintended consequences arising from prescriptive rules.

1.11 The principles are intended to be a short common-sense statement in plain English of the basic principles of investment for pension funds, enabling trustees to assess whether they are carrying out their investment responsibilities sensibly and effectively. Trustees should consider whether they are complying with the spirit and intention of the principles, rather than necessarily with the specific wording. In his original report, Myners set out how he expected that these principles would lead to a better functioning system – see box 1 below.

Review after two years

1.12 The Government promised to make a public assessment after two years of the effectiveness of the principles in bringing about change. As part of the assessment, the Department for Work and Pensions (DWP) and HM Treasury (HMT) jointly commissioned formal research of the progress made by pension schemes (undertaken by Consensus Research International). Separately, the Office of the Deputy Prime Minister (ODPM) surveyed 89 local authority schemes. The Government has also held discussions with a broad cross-section of the pensions industry, and received many submissions from interested parties. Chapter two sets out the results of this assessment. Chapter three focuses on the areas where further progress is necessary, and the measures the Government believes are necessary to encourage it. Annex A sets out proposals for a revised set of Myners principles. Annex B provides an initial Regulatory Impact Assessment.

[5] After public consultation, in October 2001, the Government published its response to the review, endorsing a – slightly revised – set of principles. These revised principles are available on line (Section D of the Government's response to the Myners Review) at: www.hm-treasury.gov.uk/mediastore/otherfiles/myners_response.PDF

[6] An exception was the recommendation that the Government legislate to require trustees to engage with investee companies where it was in the interests of the beneficiaries to do so (principle 6 (activism)). After consultation, the Government agreed to the industry's recommendation of a voluntary best practice code for shareholder engagement (the ISC statement of principles on the responsibilities of institutional shareholders and agents).

Box 1: The Myners vision of a better-functioning system[7]

"… A culture of pension fund governance would develop in which trustees would treat their responsibilities very much like the job of running a company. They would think consciously about their skills, individually and collectively, and the structures and processes which would best ensure that they carried out the investment element of their role effectively. They would develop plans as a framework for their future activity.

Trustees could choose to raise their collective level of expertise – perhaps partly by recruiting trustees with appropriate professional skills and partly by arranging further training for existing trustees. It would be unrealistic and unnecessary to expect all trustees to gain deep levels of expertise, however. Rather, the expertise of the trustee body would be concentrated by the creation of an investment sub-committee. This would enable both a more expert approach and the retention of trustees whose area of expertise was not investment. The trustees, perhaps excluding some senior executives of the company, would be paid, rewarding them for the time and professionalism required to fulfil their role successfully.

Trustees would also consider, in consultation with the scheme sponsor, the contribution which could be made to investment decision-making by in-house staff with investment expertise.

Where they felt that their skill levels were not sufficient to allow them to take decisions in an informed and sophisticated way, trustees would make greater use of delegation of investment decisions to outside providers.

Recognising the importance of the asset allocation decision to investment outcomes, trustees would devote greater attention and resources to it, whether delegating it or not, and seek to measure and assess its effectiveness. The review envisages that there would be a greater diversity of kinds of advice providers and expertise available to pension funds. In particular, if the value added by asset allocation and manager selection were measured and assessed, advisers with successful strategies, or expertise in a particular area, might operate under a number of different business models – for example, providing a different range of services, with a different charging structure.

The result would probably be a greater richness and diversity of benchmarks, with the selection of the benchmark being recognised as an important investment decision, rather than simply a technical one. Active mandates would be given where there was good reason to believe that active management could deliver outperformance, and where they were awarded, there would be realistic bands of tracking error permitted against benchmarks and challenging targets for performance. Successful active managers would manage with greater conviction. There would be clarity about the timescales over which managers were being assessed. Managers would routinely consider the possibility of intervening in investee companies as one of the means of adding value, and would account to their clients for their strategies for doing so.

The role of trustee would be more challenging, but also more rewarding in a professional sense, with clearer objectives and a more rigorous approach to the management of the fund's assets."

[7] *Institutional investment in the United Kingdom: a review*, Paul Myners, March 2001, pages 16-17

2 Findings from the review process

Introduction

2.1 This chapter describes the progress that pension schemes (and other stakeholders) have made to date in changing their behaviour in line with the Myners principles.

2.2 The original review looked to the Myners principles to achieve their effect largely through changing behaviour, rather than requiring formal compliance with a set of rules. Behavioural change, by its nature, is difficult to measure. The quantitative study undertaken by the Government as part of this review is one indicator of the extent of behavioural change. Its results have, however, been considered in the context of a much broader qualitative assessment, encompassing the earlier qualitative study, information gathered through extensive dialogue with industry stakeholders, and a series of informal roundtable seminars – involving trustees from public and private schemes, investment consultants, trade associations, fund managers, academics, government officials and the author of the Myners report. The focus has particularly been on the areas where the evidence consistently suggests progress has been lagging. In general, the findings show that these areas are where the required change is qualitative or behavioural.

Survey results

2.3 The formal research consisted of an initial qualitative case study of 14 schemes, published in November 2003[8], followed by a substantial quantitative survey of trustees representing 1,580 schemes, published in July 2004. The sample size of this quantitative survey was large, representing nearly one quarter of the estimated 6,699 schemes to which the Myners principles apply[9], providing confidence in the robustness of the picture of progress it gives. The sub-set of occupational pension schemes to which the Myners principles apply covers a large proportion – an estimated 64% – of the total membership of occupational schemes, showing the potential significance of the Myners principles as a driver for improving overall sector performance. It should also be noted that the data underlying the survey were collected between July and September 2003. Schemes can be expected to have taken further steps towards compliance since then.

Areas of progress

2.4 The survey showed that action is certainly being taken on a voluntary basis by many schemes. Over half of all trustees surveyed[10] agreed that the principles: provided guidelines for best practice; encouraged formalisation of previously ad hoc behaviour; led to trustees being better informed; and made trustees address issues they would not otherwise have considered.

[8] *The Myners Principles and occupational pension schemes, Volume 1 of 2, Findings from case study research*, (DWP Research Report No.195), November 2003

[9] That is, schemes where trustee boards were responsible for investment decision-making

[10] Survey results are weighted estimates for the universe of 6,699 schemes to which the Myners principles apply

2.5 The majority of trustee boards had formally considered five of the ten key issues covered by the principles, and had taken formal minuted decisions to act, in some way, on two principles: namely, clear objectives and asset allocation. The picture looks somewhat better when considered in terms of scheme membership; the majority of members belong to schemes that took formal decisions to act – in some way and to some extent – on six of the key issues covered by the principles. It is important to note though that the results record where schemes have acted in some way, not whether such action resulted in full implementation of the relevant principle.

2.6 According to the survey, the principles most widely considered and acted upon, by schemes covering between 74% - 80% of scheme membership, were asset allocation, appropriate benchmarks, explicit mandates and clear objectives. The principles of effective decision-making, expert advice, transaction costs and activism were also considered and acted upon by schemes covering 48% - 58% of scheme membership. Only the principles of performance measurement of advisers and trustees were considered and acted upon by schemes covering 30% or less of scheme members.

2.7 The key results are summarised in table 1.1.

2.8 Pension scheme membership size is the single most important factor explaining differences in the extent of progress. Larger schemes, with more than 1,000 members and in particular those with 5,000 or more members, were significantly more likely than smaller schemes to act on all the issues arising from the principles.

2.9 Members are overwhelmingly concentrated in larger schemes. Of the 6,699 schemes to which the Myners principles apply, 1,437 large (1,000+ members) schemes account for 91% of total members, and inside this figure, 454 very large (5,000+ members) schemes account for 78% of total members. Progress measured by the proportion of scheme membership is greater than progress measured by proportion of schemes.

2.10 The survey suggests that progress has been strongest against those principles where the action taken was quantitative, where implementation was not too burdensome for boards, or where action could be led by consultants and advisers. These principles include asset allocation, clear objectives, appropriate benchmarks and explicit mandates (which recorded the highest levels of action in the survey).

Table 1.1: Schemes considering and acting on the Myners principles

	Considered key issue covered by principle				Considered and acted on key issue covered by principle			
Percentage	By scheme membership	All schemes	Smaller schemes	Larger schemes	By scheme membership	All schemes	Smaller schemes	Larger schemes
Principle 1 Effective decision-making	**71**	48	42	65	**58**	37	32	54
Principle 2 Clear objectives	**79**	64	61	78	**74**	51	47	68
Principle 3 Asset allocation	**85**	70	68	80	**80**	52	48	69
Principle 4 Expert advice	**62**	54	52	60	**48**	34	32	42
Principle 4 Transaction costs	**61**	42	41	54	**49**	27	24	40
Principle 5 Explicit mandates	**79**	53	46	75	**75**	42	35	67
Principle 6 Shareholder activism	**65**	25	18	48	**51**	15	10	32
Principle 7 Appropriate benchmarks	**85**	66	62	82	**76**	47	42	67
Principle 8 Performance measurement (of advisers)	**36**	34	33	39	**25**	21	19	29
Principle 8 Performance measurement (of trustees)	**41**	22	20	34	**30**	15	13	23

Source: *The Myners Principles and occupational pension schemes, Volume 2 of 2, Findings from quantitative research*, (DWP Research Report No. 213), July 2004

Notes: 'smaller schemes' mean schemes with <1,000 members; 'larger schemes' mean schemes with ≥1,000 members; 'acted on' means took a formal minuted decision to act (in any respect) on the principle within 2 years after the Myners report

Weaker areas

2.11 Underlying progress has been slower in areas where the required change is qualitative or behavioural. These principles include effective decision-making, performance measurement (of trustees) and management of transaction costs. Boards have also been notably slow to consider, and then less likely to act on, the substance of activism (although the survey result by scheme membership has been boosted by the activity of some very large schemes) and challenging relationships with investment consultants.

2.12 Moreover, schemes' self-assessment of overall progress may be in itself a matter for concern. Around 70% of schemes reported that they were fully, or mostly, compliant with the principles in aggregate. But this figure was not borne out by the progress that the survey indicated had been made against each principle individually. And 18% of all schemes took no action on the principles during the two years following their publication.

2.13 More than two years after Myners, trustees are not obviously devoting significant resources to managing change. On average, trustees spent 10.6 hours per year in board meetings and, of those, devoted fewer than four hours per year to investment matters. This varied from slightly more than two hours in small schemes (with fewer than 100 members) to 5.3 hours in large schemes (with 1,000 or more members). Even in the largest schemes (those with 5,000 or more members) the average was only 9.4 hours.

2.14 Monitoring of compliance by schemes is widespread, although many schemes do this informally. Fewer than half of all schemes (44%) put the principles on the board's agenda and carried out a full review of compliance, principle by principle (although these schemes covered 78% of total membership). A further 38% of schemes reviewed compliance informally, for example, as issues arose.

2.15 The situation is weaker in relation to reporting and disclosure. Few pension funds are providing the informed commentary on the quality of compliance envisaged by the Myners review. Despite emphasis in the principles on transparency and reporting to members, only half of all schemes (53%) documented their approach to the Myners principles in their Statement of Investment Principles (SIP) or accounts, in a bulletin for members or in a statement in board minutes. An even smaller proportion of schemes (40%) had documented in their SIP or another document accessible to members the extent to which the scheme followed the principles. Most telling, only one scheme in five (22%) documented the extent to which the scheme had departed from the principles, and explained the reasons for its actions.

Areas where progress is lagging

2.16 Turning to specific principles, it is clear that progress has lagged in some key areas, where pension funds are therefore not yet likely to be serving their members' and sponsors' interests as well as they might:

- most importantly, too many trustee boards fell short of the Myners review's criterion that they have sufficient expertise to take effective investment decisions. In the two years following the publication of the Myners principles, only 37% of schemes (representing 58% of scheme membership) have considered principle 1, which sets out best practice for effective decision-making, and taken a formal decision to act in some way upon it. Low levels of trustee training provide a further indication that trustees have not been active in strengthening their resources to manage change. Only 25% of schemes said their trustees took part in formal training programmes aimed at improving knowledge of investment matters (other than induction training);

- as a result, there was still excessive reliance on investment consultants. (Eighty per cent of schemes employed an investment consultant – with more than half of all schemes (53%) relying on a pool of just eight organizations.) On principle 1 (effective decision-making), the survey confirmed that pension schemes rarely challenged the views of their investment consultants (15% of schemes had overruled a consultant recommendation during the review period). Indeed, there still appeared to be barriers to challenging relationships with investment consultants across schemes of all sizes;

- performance measurement (principle 8) remains weak. Formal reviews were undertaken only by a minority of schemes. Such reviews were marginally more likely to affect fund managers than investment consultants. Formal review of the trustees themselves was rarest of all;

- in relation to asset allocation (principle 3), the relatively high level of action recorded in the survey appears to reflect the response of many schemes to changing financial market conditions, rather than the more fundamental changes recommended by the Myners review to commit more resources to this activity;

- action in relation to explicit mandates (principle 5) has not extended to adopting the recommendations on timescales for evaluating managers, despite the importance attached to it by the Myners review. Of those schemes that had taken some action against this principle, less than 20% had specified in writing how managers should attempt to meet the objectives, or confirm that the mandate would not be terminated for underperformance alone before the expiry of the evaluation timescale;

- and action in relation to shareholder engagement has been limited: only 25% of schemes had reviewed this area, and only 15% had taken a formal minuted decision to act. Most of this 15% were relying on the activism policies of their investment managers, even though the majority stated clearly that these policies had not been influential in their choice of advisors.

Local authority schemes

2.17 The Local Government Pension Scheme (LGPS) is governed by a national statutory framework but is administered locally by 89 separate authorities, with funds ranging in size from £156 million to £6,350 million. They are constituted on a different basis to private-sector pension schemes; local councillors act as ‘quasi-trustees’ but their activities are governed by additional procedural requirements, including the provisions of the Management and Investment of Funds Regulations 1998, council standing orders, and independent monitoring by internal and external audit. Under the 1998 regulations, there is a clear duty for councillors to take professional and independent advice in carrying out their responsibilities.

2.18 Since September 2002, LGPS fund authorities have been required to disclose in their SIPs the extent of their compliance with the Myners principles and to explain any non-compliance. In autumn 2002, ODPM assessed compliance against the principles of the 89 fund authorities.

2.19 The ODPM's assessment showed significant numbers of schemes reporting that they were following the principles: 77% reported they were in full compliance with five or more of the principles; 38% said they complied with eight or more. The number of schemes considering or with plans for extending compliance was 89%. However, as with the Consensus research, self-reporting means there is a risk of potential over-reporting of progress towards implementation.

2.20 These results are not strictly comparable with the Consensus research findings because of different survey approaches and differences in timing (the ODPM survey took place more than six months before the Consensus research started). Notwithstanding this, the difference in reported compliance levels suggests that local authority pension schemes have made materially more progress towards implementing the principles. In addition, compliance on a principle-by-principle basis shows similar patterns to those observed in the quantitative survey. For example, both local authority schemes and private-sector schemes had relatively lower levels of compliance for the following principles: principle 1 (effective decision-making), principle 4 (expert advice), principle 6 (activism) and principle 8 (performance measurement).

Stakeholder discussions

2.21 In parallel with the formal research, the Government also undertook intensive discussions with the industry. Alongside gathering information through correspondence and individual meetings with stakeholders, a number of informal roundtable seminars were organised earlier in the year to focus on the main areas where the qualitative survey suggested progress was lagging. These discussions substantially confirmed the main findings from the formal research.

2.22 The following conclusions emerged from the stakeholder discussions.

- Trustees' collective skills and expertise were thought to be critical in ensuring the successful operation of a trustee board in accordance with the Myners principles. The role of the chair, both in managing the board and in ensuring the existence of a critical mass of trustees with investment expertise, is also of vital importance. Getting change in this area would be key to delivering improvements in other areas. It was acknowledged that the new legal requirement in the Pensions Act for trustees to have appropriate knowledge and understanding in investment and other relevant matters would help raise standards, although it was also emphasised that it would take time to develop and recruit a qualified and appropriately skilled pool of trustees. There was a widely shared perception that inadequate levels of resource were being devoted to strengthening trustee activities and additional steps were required to bolster levels of trustee skill and expertise.

- Both trustee and investment consultant representatives agreed that there remains a lack of clarity about respective roles, and trustees were still overly dependent on a narrow range of sources of investment advice. In addition, trustees' evaluation of consultants' performance was thought to be at a nascent stage. Consultants also needed to manage potential conflicts of interest when they acted for both pension funds and their sponsors. Sir Derek Morris's review of the actuarial profession will provide further analysis of the workings of the investment consultancy market.

- In spite of its importance in determining investment outcomes, the process of asset allocation continued to receive less attention than it deserved, being allotted inadequate resources in terms of insufficient time, money and people relative to its impact on total fund returns.

- While trustees, consultants and fund managers agreed in principle that pension funds could operate under long time horizons, the discussions suggested that there was still a mismatch between the perceptions of trustees – who believed that they operated under longer-term time horizons – and fund managers – who perceived their performance as being evaluated under shorter time horizons. Where this mismatch occurs, fund managers still have unnecessary incentives for herding and short-termism in investment.

- While acknowledging some progress in shareholder engagement since the Myners report, including the publication of the Institutional Shareholders Committee (ISC) statement of principles, there was nonetheless support for the Consensus research finding that many trustees were not active in pushing fund managers to undertake shareholder engagement. The lack of engagement activity also reflects in part the conflicts of interest facing both fund managers and some trustees. Similarly, despite improvements, it was not obvious that the quality of engagement – as evidenced by the integration of engagement into investment decision-making and asset management processes, the quantity and quality of resources and people committed to it, and the level of qualitative reporting provided by fund managers to their clients – had reached the levels envisaged by the Myners review.

- It was acknowledged that the quality and level of disclosure of progress against the principles has been relatively poor, as shown by the survey results. However, there was disagreement over the extent to which this reflected shortcomings in progress or shortcomings in disclosure. The lack of interest shown by scheme membership was given as a reason for limited progress in disclosure. It was also clear that the relative lack of informed commentary, in which trustees explained and justified their approach, meant that the establishment of further benchmarks of good practice, and their dissemination across funds, as envisaged by the Myners review, had not yet been seen.

Conclusions

2.23 In contrast perhaps to the situation when they were first promulgated, there is now a widespread acceptance that the Myners principles provide best practice guidance to investment decision-making by trustee boards. Taken together, the evidence suggests that there has been some significant progress made in implementing many of the Myners principles on a voluntary basis. But funds' own perceptions of how they measure up overall overstate the progress being made against each principle individually. There is a long way to go if the principles are to produce the genuine change in behaviour that Myners sought.

2.24 The next chapter outlines measures to address the review's findings.

3 MAKING FURTHER PROGRESS: NEXT STEPS

Introduction

3.1 The overarching message from the review findings is the importance of having qualified and appropriately skilled trustees. Trustees are at the heart of investment decision-making and the review reinforced the need to concentrate on strengthening trustee skills and expertise. Other areas for improvement – such as improving the quality of commentary on, and disclosure of, progress, clarifying relationships with investment consultants, clarifying investment time horizons, improving resources devoted to asset allocation activity, and empowering and enhancing the quality of shareholder engagement – are reliant on improvement in trustee skills and expertise.

3.2 The Government believes that pension funds would better serve their members' and sponsors' interests if the best practice embodied in the Myners principles were to be strengthened and amplified in those areas where the review has shown further efforts are needed. The proposed changes are intended to reinforce Myners' recommendations and accelerate progress towards realisation of Myners' vision of a better functioning process for trustee decision-making. But the onus for making further progress lies primarily with the industry – trustees, investment consultants and fund managers in particular. The Government looks to each of these sets of stakeholders to play its part, including building on several important industry initiatives already in train.

3.3 Action is particularly needed to:

- improve trustee expertise, and more broadly, the process of investment decision-making;
- ensure trustees make more effective use of advisors, such as investment consultants;
- improve the resourcing and quality of asset allocation activity;
- get greater clarity in investment time horizons set for fund managers;
- strengthen shareholder engagement with companies;
- improve the quality of commentary on, and disclosure about, progress made in implementing the principles.

3.4 The next sections consider next steps in each of these areas in turn.

Improving trustee expertise and the process of investment decision-making

3.5 In response to the recommendation in the original Myners report, the Government is introducing a legal requirement to ensure that, where trustees are taking decisions in relation to investment, they have the relevant degree of knowledge and expertise. The new Pensions Act will raise standards by requiring trustees to have appropriate knowledge and understanding of investment and other relevant issues, depending on the function they perform.

3.6 The Occupational Pensions Regulatory Authority (OPRA), as the precursor to the new Pensions Regulator, is working closely with a wide range of industry stakeholders to develop a Code of Practice to provide detailed guidance on how to fulfil the new legal requirements. This will provide guidance on the requirements for trustees' knowledge and understanding of the legal framework, funding, investment issues, risk and specific scheme arrangements. The Pensions Act requirements and the Pensions Regulator code are explained in more detail in box 2.

3.7 Alongside the new Pensions Act provisions, and partly in response to them, the industry is developing a range of initiatives with the aim of improving levels of trustee expertise and skills, partly through new guidance and better training. The evidence collected by the review suggests that training may not be sufficient in itself to achieve the improvement in expertise required in relation to investment matters, so that efforts to help schemes fills gaps by recruiting appropriately skilled and experienced trustees will be important:

- the National Association of Pension Funds (NAPF) is undertaking a major review of pension fund governance and the trustee model. This will examine the requirements for effective governance, assess both current and alternative governance practices, and recommend areas for improvement or change. The review is expected to be published in May 2005;
- trustees can qualify for the Pensions Management Institute (PMI) Certificate in Trustee Knowledge and Understanding through the NAPF's new online Trustee Development Programme, which will help trustees meet the Pensions Act's knowledge and understanding requirements;
- the NAPF offers a range of other training courses for trustees of different levels of experience and from different types of scheme. The PMI also provides qualifications to enhance the expertise of pension scheme managers in supporting trustees and has promoted the establishment of an Independent Trustees Group with its own professional Code of Guidance; and
- the NAPF is also developing a register of trustees to help pension schemes recruit skilled trustees.

3.8 The Government has concluded that the Myners principle on effective decision-making (principle 1) should now be strengthened so that it:

- is fully aligned with the objective standard of knowledge and understanding set in the new Pensions Act; and
- incorporates the review's conclusion that: the role played by the chair of the trustee board; having a critical mass of trustees with investment knowledge and understanding; and the availability of additional resources to support the trustee board, are all of vital importance in promoting effective investment decision-making by pension funds.

The Government believes these changes will help boards meet the requirements for improved skills and expertise required by the Pensions Act.

Box 2: The Pensions Act and the Pension Regulator code of practice

The principal mechanism for raising trustee skills and expertise to the required standard will be the statutory requirements of the new Pensions Act 2004. These provisions are intended to come into force in April 2006.

In line with Myners recommendations, the Pensions Bill provisions raise the standards of knowledge and expertise expected of trustees. Every individual who is a trustee of an occupational pension scheme will be required to have knowledge and understanding of:

- the law relating to pensions and trusts;
- the principles relating to the funding of occupational pension schemes; and
- the principles relating to the investment of the assets of such schemes.

Trustees must also be conversant with scheme documents (such as the trust deed, scheme rules and SIP) to ensure that they have an adequate understanding of matters specific to their scheme.

The level of knowledge and understanding which will be required of a trustee is that appropriate to enable him or her to exercise properly the function of trustee for his or her scheme. Some trustee functions will require greater knowledge and understanding than others and the level of knowledge and understanding will vary accordingly. The onus is on trustees to determine what level of knowledge and understanding is required and how this should be acquired.

Trustees can delegate investment functions (e.g., to an investment subcommittee, an FSA authorised fund manager or other expert, such as an investment consultant). The appropriate level of knowledge to satisfy the law will differ between trustees who are members of an investment subcommittee and those who are not (although the latter will still share responsibility for the committee's decisions). Similarly, where investment decisions are delegated to outside managers, trustees will require less knowledge. However, they will still need sufficient knowledge to challenge these advisers and hold them accountable for doing their job properly.

The Pensions Act provides for a detailed code of practice to be issued by the Pensions Regulator to outline the understanding and knowledge that might be appropriate in relation to the different functions of trustees. This is intended to help trustees understand the scope of knowledge, training, experience or qualifications necessary to meet the legal requirements. The code will also cover possible ways in which trustees might acquire this knowledge and how they might demonstrate that they meet the required standard. While the Code of Practice is not itself law, compliance and non-compliance will have evidential value in determining whether the legal requirements have been met.

Possible areas of knowledge, understanding and conversance for trustees were set out in the scope document recently published on the OPRA website[11]. Consultation on these closed at the end of November. These areas include:

- the law relating to trusts and pensions;
- investment arrangements (including behaviour of markets, asset classes, risk, overseas investment, and valuation and liquidity characteristics of asset classes);
- funding and contribution arrangements;
- strategic asset allocation issues and, for DC schemes, investment choices;
- fund management arrangements; and
- conversance with relevant documents

It is intended that the code of practice will be published in Autumn 2005.

[11] http://www.opra.gov.uk/insideopra/role/tkuc/tkuc-02.asp

3.9 The chair has a critical role in all pension funds in ensuring that the board as a whole has appropriate skills to address its responsibilities, and sets aside the appropriate time and resources to support investment decisions. Accordingly, the Government proposes to amend principle 1 to state that:

- the chair of the board should be responsible for ensuring that trustees taking investment decisions are familiar with investment issues and that the board has sufficient trustees for that purpose.

In addition, reflecting the critical mass of assets managed by the very largest schemes, and the vital importance therefore of their investment decision-making, the principle should also state that:

- funds with more than 5,000 members should have access to in-house investment expertise equivalent at least to one full-time staff member who is familiar with investment issues; and
- for funds with more than 5,000 members, the chair of the board and at least one-third of trustees should be familiar with investment issues (even where investment decisions have been delegated to an investment subcommittee).

3.10 In many cases, smaller funds would not have the resources and flexibility to meet these requirements.

3.11 The Government proposes that the relevant standard for familiarity with investment issues in this context should be that required by the Pensions Act of trustees on an investment subcommittee to whom investment decisions have been delegated by the board (which is also the standard expected of all trustees where there is no investment subcommittee). This is equivalent to the standard in the Myners principles for trustees electing to take investment decisions, namely sufficient expertise and appropriate training to be able to evaluate any advice taken.

3.12 Even where a board has delegated investment decision-making to an appropriately qualified investment subcommittee, it is clear that the board needs a minimum core of trustees who are familiar with investment issues. The responsibilities of the chair in leading the board are such that the chair will almost invariably need to comply with this standard. A figure of one-third of trustees meeting this standard represents a reasonable minimum to ensure adequate understanding and challenge in selecting and managing advisers and to provide sufficient trustees at least to staff up the investment subcommittee.

3.13 The Government recognises that it will take time to develop a qualified and appropriately skilled pool of trustees, which is essential for the Myners' objectives to be achieved. This reflects factors such as the need for incumbents' terms to expire, the time taken to assess boards' skill requirements and, where necessary, to recruit appropriately skilled and experienced people, and inertia.

3.14 A number of initiatives will help maintain momentum. This includes the NAPF's register of potential trustees available to help boards in filling skills gaps. In addition, the Government is considering the establishment of a Trustee Forum to promote the role of the trustee in pension fund management. This would be composed of trustees, with a remit to act as an additional channel of communication between trustees and Government. It would be expected to help promote the role and effectiveness of trustees, strengthen the voice of 'lay' (i.e., non-professional) trustees in the debate on pension issues and provide support and encouragement to trustees of small schemes. The Department for Work and Pensions is consulting on how the forum might be taken forward.

3.15 The Government wants to work with the industry to strengthen the trustee pool and is open to proposals that would help achieve this important goal effectively. It would particularly welcome views on this issue in responses to the consultation.

3.16 It is clear from the Government's review that resource constraints continue to make it difficult for some schemes to achieve best practice governance. Myners' review demonstrated that there would be clear benefits for all parties if sponsors of pension schemes were to give higher priority to supporting trustees' activities, by providing additional support in terms of human and financial resources (subject to the requirement to ensure this did not result in any conflict of interest). This point remains valid and the Government strongly encourages sponsors to consider whether providing further resources would be productive.

Making more effective use of advisers

3.17 Myners identified an over-reliance by trustees on their investment consultant advisers. Good advice alone is insufficient; collectively trustees require the experience and skills to provide sophisticated challenge to advisers. Over-dependence of decision makers on their advisers can lead to confusion of roles: trustees tend to feel they lack the expertise to make decisions, while the advisers lack the mandate to do so.

3.18 Myners' solution to this encompasses several linked strands. First and foremost, trustee skills and expertise must be strengthened to ensure trustees are capable of providing the appropriate level of challenge. Secondly, advisory contracts for actuarial and investment advice should be separated and competed for, to increase market capacity and improve the quality and focus of advice received. Thirdly, trustees should evaluate and report on adviser performance, becoming more demanding and discerning customers.

3.19 It was clear from the formal research, and our stakeholder discussions, that only modest progress has been made in trustees' developing more effective client relationships with advisers, particularly investment consultants. Trustees' evaluation of investment consultants to date is generally neither widespread, nor particularly effective (although this is in part because of difficulties in measuring the quality of advice in respect of decisions with long-term pay-offs).

3.20 Fundamental to improvement is raising levels of trustee skills and expertise, giving trustees the capacity to engage effectively with, and challenge, investment consultants. Measures the Government proposes to address this problem are set out in the section on improving trustee expertise and the process of investment decision-making above.

3.21 Improved trustee skill levels need to be complemented by a better framework for clarifying and managing the relationship with investment consultants. The NAPF is updating and expanding its guidelines for trustees on how they should work with, and evaluate, their investment consultants, including such issues as performance measurement, managing conflicts of interest and determining the optimal mix of risk and return. The NAPF plans to publish this guidance in March 2005.

3.22 Performance evaluation mechanisms take time to develop and become established as best practice. The Government believes trustees' efforts in the area of performance evaluation would be strengthened by an independent informed commentary on compliance which could be provided through the 'FRAG-style' report discussed in paragraphs 3.58 - 3.62.

3.23 The Government is also relaxing some regulatory requirements as part of its review of the Financial Services and Markets Act 2000 (FSMA)[12] which will have a modest impact in encouraging more effective use of advisers. Trustees who are not authorised under FSMA are currently not permitted to take routine or day-to-day investment decisions, except in a limited range of cases (principally investment in private equity limited partnerships) and then only if they follow advice from an authorised person[13]. In future, unauthorised trustees will be required only to obtain and consider independent advice in respect of this limited range of decisions; they will no longer be required to act in accordance with it. Moreover, in future they will also be able to take investment advice for these decisions from a wider range of sources, including designated professional services firms that act under Part XX of FSMA, such as lawyers, chartered accountants and actuaries. These changes are consistent with the strengthening of skills and expertise among trustees, are likely to help increase competition among investment advisers, and to help raise the quality of investment decision-making.

Greater transparency of transaction costs

3.24 Another area in which steps are being taken to ensure more effective use is made of advisers is the management of transaction-related costs, principally broking commissions incurred by fund managers on behalf of pension funds. The Myners review found that disclosure of what these costs are and how they are incurred is opaque, in part because the commission frequently 'bundles' research and other, unrelated (or 'soft'), costs with the cost of executing transactions. As a result, pension fund clients have little understanding of such costs, accountability to clients by fund managers for such costs is weak and fund managers face a conflict of interest in managing such costs in clients' interests.

3.25 Hence, the Myners principles state that trustees (or their advisers) should have a full understanding of transaction-related costs and should have an active strategy for ensuring that these costs are properly controlled. The original review also recommended that clients' interests would be better served if fund managers were required to absorb the cost of commissions paid, as this would provide appropriate incentives for fund managers to manage these costs. After further consideration, it was announced that the FSA would address this issue, bringing forward its own review of soft commission arrangements and bundled broker services.

3.26 The FSA considered whether it should require fund managers to rebate the non-execution part of broking commission to clients. However, it has decided that a disclosure-based regime might be more efficient and, on 26 March 2004, it announced that it would give the industry the opportunity to develop a rigorous transparency regime for disclosure of such costs.

[12] *Financial Services and Markets Act two year review: Changes to secondary legislation*, HM Treasury, November 2004, chapter 7

[13] Trustees who are authorised persons under FSMA are not bound by these restrictions

3.27 The outline of such a regime is developing. The FSA has specified that the services that can be paid for through trading commission should be limited to research and execution services only. On 10 November 2004, the FSA set out its views on the definition of research and execution services (research embodies value-added analysis with clear intellectual content; execution services are those demonstrably linked to the arranging and conclusion of a transaction). The industry has committed to meeting the FSA's timetable to provide proposals on disclosure by the end of 2004 and the FSA has said it is confident that it will develop robust mechanisms that are able to differentiate execution costs. This, in turn, would drive more efficient decisions on the use of execution and research services. However, the FSA has also said that if the industry fails to develop such a regime, it will introduce regulatory measures to deliver the outcomes required, whether by requiring fund managers to rebate the costs of research back to clients or by other means.

Improving asset allocation activity

3.28 The Myners review identified a mismatch between the importance of asset allocation to investment outcomes and the low level of resources committed to it by trustees, both in terms of trustee time and fund resources (for example, in comparison to the resources devoted to portfolio management). Accordingly, the principles enjoin pension funds to give strategic asset allocation decisions a level of attention, and concomitantly resources, that fully reflects the contribution these can make to achieving the funds' investment objectives.

3.29 The Consensus research indicates there has been only limited progress in improving the resources devoted to asset allocation activity, with trustees still spending very low levels of time considering investment issues. While some in the industry assert that there are encouraging signs of underlying movement (for example, consultants suggest that there has been an increase in re-tendering of their contracts), it seems clear that many trustees have failed to seriously address this challenge so far.

3.30 The key to changing behaviour in line with the principle is to improve the underlying process for asset allocation. This requires a significantly greater level of skill and expertise from trustees in order to be able to deal with the issue of asset allocation, and to have the confidence to embrace benchmarks more consistent with the long-term interests of their membership. This is already being addressed through the measures to improve trustee skills and expertise. It also requires trustee willingness to devote additional resources to the task: to improve the amount of time spent on asset allocation and to increase the financial and staff resources devoted to it. The Government believes the change to principle 1 to require large funds to have access to in-house investment expertise equivalent to one full time staff member who is familiar with investment issues will assist in the latter respect. Additional advice and expertise provided by scheme sponsors would reinforce this. Better contractual structures for the engagement of investment consultants (see paragraph 3.21 above) will also contribute, by providing a better framework for clarifying and contracting for the appropriate advisory requirement.

3.31 In addition, the Government, as part of its review of FSMA[14], is introducing further deregulatory measures to enable pension fund trustees to make a more diverse range of investment decisions. Unauthorised trustees[15] will be permitted to make directly the decision to invest in pooled investment vehicles (e.g., unit trusts, investment trusts and open-ended investment companies) and in contracts of insurance (e.g., annuities), on the same basis as they will be permitted to make the decision to invest in private equity limited partnerships (refer to paragraph 3.23 above). This change will help facilitate strategic asset allocation decisions by reducing discrimination between asset classes.

3.32 The Government also proposes to amend principle 4 (expert advice). Myners initially recommended that trustees split the contracts for investment advice and actuarial advice and open these to separate competition in order to ensure trustees received the appropriate specialised advice from a diverse and competitive range of suppliers. Over time, this principle will help increase the breadth of advice available to trustees. However, the Government has concluded that there would be additional benefit in encouraging the further splitting of contracts for investment advice into contracts for advice on strategic asset allocation and advice on manager selection. This would provide a clearer focus on asset allocation activity and would allow more parties, including fund managers, to compete for the provision of asset allocation advice. In some cases, having considered the decision, funds may conclude that the benefits of combining asset allocation advice with other advice, (e.g., for asset liability modelling) outweigh those of separate contracts. In such cases, it is open for funds to explain their reasons for choosing not to follow the revised principle.

Getting greater clarity on investment time horizons

3.33 Myners identified that pension fund clients are in many cases overly-wedded to peer group benchmarks, which may have little reference to the members' long-term interests, and are frequently vague about the time horizons over which managers' performance will be judged. These inappropriate and/or unclear investment objectives can encourage managers to adopt an investment approach that is not fully aligned with their clients' objective or interests, such as herding around a benchmark.

3.34 Myners' answer was for trustees to explicitly consider time horizons in the context of clear and appropriate investment objectives and to ensure these are captured in fund management mandates with clear timescales for performance measurement and evaluation. Moreover, trustees need to have the capacity for informed understanding, for example, that underperformance against a benchmark for a period is permissible and fund management mandates need not be terminated, where this is consistent with a longer-term investment strategy.

3.35 It is clear from the Consensus research that trustees and fund managers need to make more progress in agreeing clear mandates for the timescales over which the performance of fund managers is measured (although in doing so they must, of course, have the flexibility to tailor the mandate to scheme requirements). While 47% of schemes (covering 76% of total scheme membership) have taken formal minuted decisions to act on the issue of appropriate benchmarks, only half (52%) of these have set specific performance timescales at all, and less than half of that sub-group had made clear that underperformance outside the specific timescale would not alone be a reason for losing a mandate.

[14] *Financial Services and Markets Act two year review: Changes to secondary legislation*, HM Treasury, November 2004, chapter 7

[15] i.e., trustees who are not authorised persons under FSMA

3.36 The room for improvement is also indicated by continuing sharp mismatch in perception between the two groups. A recent survey by MORI for the NAPF and Investment Management Association (IMA)[16] showed that most IMA members surveyed agreed that the way in which mandates are structured promotes an unduly short-termist approach (61% agreed, 24% disagreed), while most NAPF members disagreed (50% disagreed, 29% agreed).

3.37 This failure to agree explicit investment time horizons is, however, another symptom of continued shortcomings in levels of trustee skill and expertise. Continuing improvement in these is the key to ensuring greater clarity of investment time horizons.

3.38 The Government proposes to amend principle 5 (explicit mandates) to clarify and simplify the requirements that mandates should contain clear timescales for performance measurement and evaluation. While Myners' original point – that mandates should not be terminated before the expiry of the evaluation timescale for underperformance alone – remains valid, the Government believes the principle will be clearer and simpler if it refers simply to the need for clear timescales for performance measurement and evaluation.

3.39 Trustees should be clear about what sort of strategy they wish to pursue, and thus the benchmarks against which performance should be evaluated, and the time horizon over which that strategy would generate value, and thus the time horizon against which performance should be evaluated. This should be part of an informed dialogue between trustees and their advisers, and fund managers, leading to an understanding that should be recorded in the mandate given by trustees. Coupled with explicit assurance that mandates will not be prematurely terminated for short-term underperformance alone, this will reduce uncertainty and increase fund managers' incentives to pursue that strategy, rather than engage in activities such as herding around a benchmark. For their part, fund managers need to be very clear about what trustees are expecting them to achieve, and over what time horizon.

3.40 The Government would like to see these points reflected in new models of fund managers' mandate that are both practical and able to provide greater clarity on the time horizons fund managers should pursue. The Marathon Club has been established by a group of senior institutional investors at pension funds, endowments and foundations to encourage responsible and active share ownership. It has set in train work to look further at the barriers to the establishment of long-term mandates with fund managers. The Government looks forward to this work leading to practical proposals for change and improvement.

Promoting more effective shareholder engagement

3.41 Myners found that there was a general reluctance to tackle underperformance in investee companies, particularly in taking pre-emptive action to prevent troubled companies developing serious problems. In his view, if fund managers are to fulfil their duty of maximising value for their clients, then there will be times – more than at present – when it is their responsibility to engage with investee company management. In turn, the Myners review argued that trustees must recognise the importance of shareholder engagement in adding value, and work with advisers to select and mandate fund managers accordingly. While the evidence is not conclusive, there is a growing body of research suggesting a linkage between performance and the good governance to which effective engagement contributes.

[16] *NAPF/IMA Short-Termism Study Report*, MORI, September 2004

3.42 In the Government's view, effective engagement requires informed consideration and judgement and cannot be achieved by a 'box ticking' approach based on mere formal compliance. It requires integration into investment decision-making and asset management processes, and should not be treated as an 'add-on' or compliance activity. The quality of engagement – which reflects the recognition it is given throughout the investment chain, and the quality and seniority of the people and level of resource allocated to it – is critical to its effectiveness. Trustees, and other clients of fund managers, should therefore be looking for qualitative reporting from managers on how engagement responsibilities have been exercised, and not simply quantitative schedules of decisions taken.

3.43 Myners recommended that trustees should incorporate the principles of the US Department of Labor Interpretative Bulletin on activism into fund management mandates (and that the Government should in due course incorporate these in legislation), and trustees should further ensure that managers have an explicit strategy for activism in accordance with these principles.

3.44 After consultation, the Government decided not to incorporate the Department of Labor principles into law or require fund managers to incorporate them into mandates. The Government accepted proposals from the Institutional Shareholders Committee (ISC) that the ISC produce a statement of principles on the responsibilities of institutional shareholders and agents. These principles would be adopted and complied with by the ISC's membership as a voluntary code of best practice, and appropriate references would be included in agreements between investment managers and their clients. (As part of this, appropriate references to the principles would be incorporated into the Investment Management Association's model terms for discretionary fund management). The ISC's statement of principles was published in October 2002.

3.45 The current Myners principle 6 (activism) reflects the position prevailing before the publication of the ISC statement of principles. The Government proposes to amend the principle to replace the reference to the US Labor Department Interpretative Bulletin with an analogous requirement for trustees to comply with the ISC statement of principles, ensure that fund managers' mandates incorporate these principles and monitor and evaluate the performance of managers against them. This will remove any ambiguity and make clear the responsibility of trustees for ensuring appropriate shareholder engagement is undertaken. As revised, principle 6 would state:

- Trustees should comply with the Institutional Shareholders Committee statement of principles on the responsibilities of institutional shareholders and agents, and ensure that the principles are incorporated into fund managers' mandates. In line with the principles, trustees should also ensure that managers have an explicit strategy, elucidating the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy.

3.46 Other measures which support adoption and implementation of the ISC statement of principles by improving the quality and levels of shareholder engagement include:

- the development by the Shareholder Voting Working Group of practical proposals to streamline the voting system[17]. These will make it more cost-effective and efficient, and reduce the incidence of 'lost votes';
- the NAPF is preparing a new 'made simple' publication for trustees to help them exercise proxy votes. This will be published early in 2005;
- the NAPF has also revisited and strengthened its case committee process. This provides a vehicle for dialogue between institutional shareholders and the managers of an investee company on strategic and governance issues.

3.47 The Government has committed to assessing the impact of the ISC statement of principles in achieving behavioural change after two years. It will be particularly looking at the extent to which engagement has been integrated into investment decision-making and asset management processes, the quantity and quality of the resources and people committed to it, and the level of qualitative reporting provided by fund managers to their clients. While the Consensus research suggested the uptake of this Myners principle had been at the lower end of the scale, the Government wishes to see the evidence on the impact and effectiveness of the statement of principles produced by the ISC's review of progress before reaching its own conclusions.

Importance of scheme size

3.48 The vast majority of members (91%) and assets are concentrated in a relatively small number of what the Consensus research classified as large and very large pension schemes. The formal research also showed that the larger the scheme is, the more likely it is that it has made progress against the Myners principles.

3.49 The Myners principles are drafted to have equal validity as guidance for all schemes, irrespective of size: they are, for the most part, about decision-making processes. However, the Government recognises that smaller schemes may face a resource constraint in complying with some aspects of the principles. At the same time, the Government believes that it is important that smaller schemes should seek where practical to comply with the principles. Not all the principles are necessarily more difficult for small schemes to implement. Where scheme size may make certain elements of the principles difficult to implement, the appropriate course of action is for the scheme to explain the reasons why it has chosen not to implement the elements in question.

3.50 In an initiative that may help smaller schemes achieve more effective implementation of the principles, an industry working group is examining ways to enable the establishment of trust-based multi-employer pension schemes for non-associated employers, which would reduce diseconomies of scale, thus helping stimulate the development of workplace pension arrangements amongst smaller employers. The Government is keeping in close touch with progress.

[17] *Review of the impediments to voting UK shares*, Report by Paul Myners to the Shareholder Voting Working Group, January 2004

Local authority schemes

3.51 ODPM is currently consulting on how LGPS fund authorities should engage key stakeholders (e.g., trades unions, scheme members and pensioner members) as part of the decision-making process. The Treasury will liaise with ODPM to ensure that the revisions to Myners principles arising from this review, and this broader review of scheme communications and representation, are properly reflected in the guidance on Myners principles for local authority schemes issued by the Chartered Institute of Public Finance and Accountancy (CIPFA).

Improving the quality of commentary and disclosure

3.52 The Myners review concluded that compelling pension funds to comply with the Myners principles through regulation would be a blunt instrument, which would not easily accommodate the diverse situations of funds. The example of the Combined Code shows that a best practice model, backed with disclosure requirements, can be a powerful force for behavioural change. The original review therefore proposed that pension funds set out annually in their SIP what they are doing to comply with each of the principles, and explain publicly the reasons where they chose not to comply. The expectation was that this would provide an informed commentary, in which trustees explained and justified their approach, and lead over time to the establishment of benchmarks of good practice, and their dissemination across funds. Greater transparency would also increase accountability, by enabling stakeholders to oversee the decisions made on their behalf more effectively. However, the review concluded that if the industry was not willing to adopt the principles voluntarily, the scale of the distortions it had identified justified legislative enforcement of disclosure.

3.53 The Government made clear in its response to the Myners review that it expected pension funds to publicly disclose their compliance with the Myners principles on a voluntary basis[18]. However, the research shows that performance against this expectation so far has been relatively poor. Only 40% of schemes set out for members the extent to which the scheme has followed the principles (and only 22% explained where they had departed from the principles and the reasons why). Moreover, such disclosures have, in general, been less rich and informative than envisaged by the original review and the informed dialogue, seen by Myners as essential to establishing benchmarks of good practice and improving accountability to stakeholders, has not yet emerged.

3.54 To some extent, the pressure from pension fund members on trustees to take action against the Myners principles is relatively weak, because fund members are widely dispersed, and have few levers for collective action. But there is growing external interest in how trustees are performing against the Myners principles, increasing the incentives for trustees to produce informed and high-quality commentary. For example, the TUC is planning to use its trustee network, which involves over 1,000 trustees in several hundred schemes, to raise awareness of the Myners principles, to encourage boards to bring the principles into the heart of decision-making, and to use them as a progress benchmark. And some credit ratings agencies now offer trustees an assessment of key financial and other scheme parameters, which could assist with sponsor negotiations and provide additional information for dissemination to members.

[18] *Myners Review: Institutional Investment in the UK, The Government's response*, HM Treasury & the Department for Work and Pensions, October 2001

3.55 The Government welcomes these initiatives and others like them. Over time, partly in response to such pressures, the voluntary approach to disclosure of progress through the 'comply or explain' approach, could well deliver the outcomes which the original review was expecting to see. However, the Government considers that there would be benefits – to pension funds and their members, as well as more widely – in making progress more quickly.

3.56 The Government has therefore considered whether the quality of disclosure would be enhanced by requiring private-sector pension schemes to disclose in their SIPs whether they complied with the Myners principles and, if not, to explain why not. This would be analogous to the requirement already imposed on local authority pension schemes. However, the Government has concluded, at this stage, against this.

3.57 Monitoring this requirement for the large body of private-sector schemes would not be easy. There might be little pressure from members on trustees to comply because, as noted above, they are widely dispersed. On the other hand, external monitoring of compliance by Government would be costly and time-consuming, and could result in the process becoming an uninformative 'box ticking' exercise.

3.58 The Government therefore proposes to continue to advocate that funds should, voluntarily, set out annually in their SIP what they are doing to comply with each of the principles, and to explain the reasons where they choose not to comply. However, it is also attracted to supplementing this approach through an additional mechanism. Trustees would report annually to members on their performance against the principles, after having the report reviewed by an independent party, such as the scheme's auditors. The information provided by such a review could complement the disclosures in the SIP, contributing to a more detailed and better quality commentary on compliance.

3.59 Such a review could be similar in the structure to the FRAG 21/94 report[19] (which is prepared by securities custodians to give assurance to their clients on the efficacy of internal control procedures). It could also have similarities to the review of compliance with elements of the Combined Code which auditors undertake under the Listing Rules.

3.60 Guidance would provide a framework for the independent reviewer to assess performance. The process of independent review would have several benefits. In addition to the information provided to members, other trustee boards and external stakeholders, it would provide trustees with feedback on their performance, within the discipline of a formal reporting framework. It would also provide an incentive for trustees to improve both their compliance with the Myners principles and to demonstrate more accountability to members (in part substituting for the acknowledged limitations of member monitoring).

3.61 The probable cost and level of work involved suggests that smaller schemes could face a resource constraint in undertaking such reporting. In addition, larger schemes would derive the most benefit. Accordingly, the Government proposes that 'FRAG-style' reporting should be adopted only by very large pension funds (i.e., those with more than 5,000 members).

[19] A report on internal controls of investment custodians made by the directors of the custodians and tested by the reporting accountants, in accordance with guidance called "FRAG 21/94 (revised)" issued by the Audit Faculty (formerly Financial Reporting and Auditing Group) of the Institute of Chartered Accountants in England and Wales.

3.62 The Government would like to see whether such practice could be established on a voluntary basis, based on guidance from professional bodies. The Government proposes to chair a working party, including the NAPF and other stakeholders, which will work on developing proposals for 'FRAG-style' reporting. These proposals will then be submitted for consultation. Terms of reference for this work are being discussed.

3.63 Separately, the Government has concluded that disclosure and accountability would be further enhanced if trustees – who are already required to assess their own procedures and decisions[20] – were to publish the results of such assessment and make these available to members. Trustees are already required to publish the results of the assessment of the performance of advisers and fund managers under principle 10 (regular reporting). Including a requirement to report on the performance of trustees would provide members with additional information to assess the stewardship of their representatives. The Government proposes to amend principle 10 accordingly.

3.64 Principle 10 also requires trustees to send key information (from the SIP and from the results of their monitoring of the performance of advisers and fund managers) annually to fund members. Myners' view was that such information should be publicly disclosed in order to encourage behavioural change. It is desirable to enhance such disclosure, where possible to do so at minimal cost. The Government has therefore concluded that a pension fund should make its key information disclosures publicly available on a website. The Government has also concluded that, while it is possible that some smaller funds may not find it cost effective to operate a website, there is no good reason for the largest funds (i.e., those with more than 5,000 members) not to have a dedicated website. It proposes to amend principle 10 to reflect both of these points.

3.65 Incorporating all of these changes, the Government proposes to amend principle 10 (regular reporting) to state:

- Trustees should publish their Statement of Investment Principles and the results of their monitoring of their own performance, and that of advisers and managers. They should send key information from these annually to members of these funds, as well as posting this on a fund website, including an explanation of why the fund has chosen to depart from any of these principles. It is good practice for funds with more than 5,000 members to have a website dedicated to the fund.

[20] Under principle 8 (performance measurement)

Conclusions

3.66 The draft revised Myners principles, incorporating the various changes described above, are attached at Annex A, along with an initial Regulatory Impact Assessment at Annex B. The Government welcomes comments on these and on any other aspects of its proposals by 16 March 2005.

3.67 The Government remains committed to achieving the goals set out in Myners' original review and to improving the efficiency of institutional investment decision-making. The Government believes that this review exercise has been very helpful, not only in itself, but also as a catalyst for further progress towards compliance with the Myners principles. This progress needs to be maintained over the next few years. The Government will continue to keep the position under review. The NAPF has agreed to undertake a further review in 2007 of the progress its members are continuing to make against the Myners principles, and put the results to Government. In light of the NAPF's evidence, the Government will assess the degree to which the principles have resulted in behavioural change and consider whether there still remains a need for further policy action, by the end of 2007.

A Proposed revisions to the Myners principles

Proposed additions to the principles below are underlined; deleted text is not shown. The proposed changes are shown applied to the principles for defined benefit schemes. Corresponding changes will be made to the principles for defined contribution schemes.

1. Effective decision-making

Decisions should be taken only by persons or organisations with the skills, information and resources necessary to take them effectively. Where trustees elect to take investment decisions, they must have sufficient expertise and appropriate training to be able to evaluate critically any advice they take.

Trustees should ensure that they have sufficient in-house staff to support them in their investment responsibilities. <u>Funds with more than 5,000 members should have access to in-house investment expertise equivalent at least to one full-time staff member who is familiar with investment issues</u>. Trustees should also be paid, unless there are specific reasons to the contrary.

It is good practice for trustee boards to have an investment subcommittee to provide the appropriate focus. <u>The chair of the board should be responsible for ensuring that trustees taking investment decisions are familiar with investment issues and that the board has sufficient trustees for that purpose. For funds with more than 5,000 members, the chair of the board and at least one-third of trustees should be familiar with investment issues (even where investment decisions have been delegated to an investment subcommittee).</u>

Trustees should assess whether they have the right set of skills, both individually and collectively, and the right structures and processes to carry out their role effectively. They should draw up a forward- looking business plan.

2. Clear objectives

Trustees should set out an overall investment objective for the fund that:

- represents their best judgement of what is necessary to meet the fund's liabilities given their understanding of the contributions likely to be received from employer(s) and employees; and
- takes account of their attitude to risk, specifically their willingness to accept underperformance due to market conditions.

Objectives for the overall fund should not be expressed in terms which have no relationship to the fund's liabilities, such as performance relative to other pension funds, or to a market index.

3. Focus on asset allocation

Strategic asset allocation decisions should receive a level of attention (and, where relevant, advisory or management fees) that fully reflect the contribution they can make towards achieving the fund's investment objective. Decision-makers should consider a full range of investment opportunities, not excluding from consideration any major asset class, including private equity. Asset allocation should reflect the fund's own characteristics, not the average allocation of other funds.

4. Expert advice

Funds should contract separately for actuarial, strategic asset allocation and fund manager selection advice and these contracts should be opened to separate competition. The fund should be prepared to pay sufficient fees for each service to attract a broad range of kinds of potential providers.

5. Explicit mandates

Trustees should agree with both internal and external investment managers an explicit written mandate covering agreement between trustees and managers on:

- an objective, benchmark(s) and risk parameters that together with all the other mandates are coherent with the fund's aggregate objective and risk tolerances;
- the manager's approach in attempting to achieve the objective; and
- clear timescale(s) for performance measurement and evaluation.

The mandate and trust deed and rules should not exclude the use of any set of financial instruments, without clear justification in the light of the specific circumstances of the fund.

Trustees, or those to whom they have delegated the task, should have a full understanding of the transaction-related costs they incur, including commissions. They should understand all the options open to them in respect of these costs, and should have an active strategy - whether through direct financial incentives or otherwise - for ensuring that these costs are properly controlled without jeopardising the fund's other objectives. Trustees should not without good reason permit soft commissions to be paid in respect of their fund's transactions.

6. Activism

Trustees should comply with the Institutional Shareholders Committee statement of principles on the responsibilities of institutional shareholders and agents, and ensure that the principles are incorporated into fund managers' mandates. In line with the principles, trustees should also ensure that managers have an explicit strategy, elucidating the circumstances in which they will intervene in a company; the approach they will use in doing so; and how they measure the effectiveness of this strategy.

7. Appropriate benchmarks

Trustees should:

- explicitly consider, in consultation with their investment manager(s), whether the index benchmarks they have selected are appropriate; in particular, whether the construction of the index creates incentives to follow sub-optimal investment strategies;
- if setting limits on divergence from an index, ensure that they reflect the approximations involved in index construction and selection;
- consider explicitly for each asset class invested, whether active or passive management would be more appropriate given the efficiency, liquidity and level of transaction costs in the market concerned; and
- where they believe active management has the potential to achieve higher returns, set both targets and risk controls that reflect this, giving the managers the freedom to pursue genuinely active strategies.

8. Performance measurement

Trustees should arrange for measurement of the performance of the fund and make formal assessment of their own procedures and decisions as trustees. They should also arrange for a formal assessment of performance and decision-making delegated to advisers and managers.

9. Transparency

A strengthened Statement of Investment Principles should set out:

- who is taking which decisions and why this structure has been selected;
- the fund's investment objective;
- the fund's planned asset allocation strategy, including projected investment returns on each asset class, and how the strategy has been arrived at;
- the mandates given to all advisers and managers; and
- the nature of the fee structures in place for all advisers and managers, and why this set of structures has been selected.

10. Regular reporting

Trustees should publish their Statement of Investment Principles and the results of their monitoring <u>of their own performance, and that </u>of advisers and managers. They should send key information from these annually to members of these funds, <u>as well as posting this on a fund website,</u> including an explanation of why the fund has chosen to depart from any of these principles<u>. It is good practice for funds with more than 5,000 members to have a website dedicated to the fund.</u>

B INITIAL REGULATORY IMPACT ASSESSMENT

Objective The purpose of the Myners principles is to improve the efficiency of the investment decision-making of pension fund trustees. The flow through effects of this would be seen in terms of higher 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. The proposed revisions to the Myners principles, on which the Government is consulting, address some gaps which have arisen in the implementation of the principles and are intended to ensure the full benefits originally envisaged are achieved.

Background This initial Regulatory Impact Assessment (RIA) covers proposed revisions to the Myners principles, arising from the Government's review of the effectiveness of the Myners principles in achieving behavioural change.

Myners reviewed the efficiency of institutional investment decision-making for the Government. He recommended that pension funds should adopt a series of best practice principles (the 'Myners principles') to address deficiencies in their investment decision-making and improve performance. Myners recommended that the principles be voluntary, but that pension funds should publicly report on their compliance and where they chose not to comply, to explain the reasons for this. He also recommended that the Government review the success of the voluntary approach in achieving the desired behavioural change after two years in operation. After consultation, the principles were promulgated in October 2001.

The Government has now completed its review and proposes a small number of revisions to clarify and strengthen the Myners principles. All of the revisions are intended to improve the effectiveness of the principles in achieving improvements in investment decision-making and some may have an impact on industry costs. This RIA provides an initial assessment of costs and benefits.

The Government has already consulted extensively during the review. It is now proposing to consult on the proposed revisions to the Myners principles and on the initial assessment of costs and benefits in this RIA. All stakeholders are encouraged to send their written comments to the address given at the front of this report as soon as possible, and at the latest by 16 March 2005.

It should be noted that the Government has not yet had an opportunity to consult with stakeholders on the initial assessment of costs and benefits. This initial RIA is intended to facilitate that process. A revised RIA will follow.

Risk assessment The proposed revisions are intended to facilitate the achievement of the original Myners objectives. The revisions are based on detailed research on the extent to which pension funds have adopted the principles to date and on consultation with a wide range of stakeholders. If the revisions are not made, the risk is that the principles are implemented less effectively and the Myners objectives are only partially achieved. In particular, there is a risk that implementation will be uneven, and that progress against those principles where implementation has been shown to be slower, will continue to lag.

Options

Option one – take no action. Under this option, the principles would remain unchanged. Use of the principles by trustees would be likely to continue to grow and substantial benefits would be realised. However, the principles would not fully reflect experience and changes in best practice. Thus, incremental benefits would be lost, while incremental costs would be avoided.

Option two – revise the principles in line with the review conclusions. Under this option, the principles would be revised to reflect the experience of two years of implementation. The revisions are focused on areas where implementation has lagged and where the benefit of revision is judged to be greatest. This would be expected to increase the uptake and utility of the principles, leading to improved investment decision-making.

Rejection of other options. The Government has not assessed intermediate options of implementing some revisions but not others. The revisions are a consistent package aimed principally at reinforcing trustee governance capacity. If consultation suggests the need for modification of some elements of the package, this will be addressed in the final RIA.

Nor has the Government assessed any option that involves scaling back the original Myners principles. The review confirmed widespread acceptance of the Myners principles as best practice and confirmed that the main issue facing the Government and the industry is their effective implementation.

Costs and benefits

Who is affected

Out of a total of more than 100,000 pension schemes in the UK, an estimated 6,699 occupational pension schemes make investment decisions through trustee boards and therefore fall within the scope of the Myners principles. These schemes tend to be the larger ones. Of the 6,699 schemes, some 454 are classified as very large, because they have more than 5,000 members. Very large schemes represent 78% of scheme membership of the pension schemes covered by the Myners principles, and therefore a very substantial proportion of total scheme assets.

In addition, the changes to pension fund practice engendered by the Myners principles will have a downstream impact on the way in which investment consultants and fund managers provide services to pension funds, and indirectly on the investment decisions of investee companies.

Costs

The proposed revisions are clarifications and amplifications intended to facilitate achievement of the original Myners objectives, which makes it hard to disentangle any incremental impact on cost. It is arguable that there is little, if any, incremental impact on cost because the revisions are simply explaining in greater detail what pension funds needed to do to meet Myners standards. However, the Government has concluded that it is more appropriate to take a broader view of the potential incremental costs for the purpose of impact assessment.

The cost of implementation of the revisions to the Myners principles is mitigated because the Myners principles are a voluntary best practice code. The cost is significantly lower than it would be for equivalent prescriptive regulation. In determining the costs of implementation, one must take into consideration that some pension funds will already comply with the revisions. Because the principles are focused on outcomes, some funds will have in place or be able to find alternative lower-cost ways of achieving these. Similarly, some funds will conclude that, given their specific circumstances, it is not cost effective for them to comply fully and they will instead explain the reasons for this to their members. The Government does not have good data on the extent of this cost mitigation and one purpose of this consultation exercise is to seek better data.

Three of the proposed revisions to the principles could increase industry costs.

Additional staff resource to support trustee decision-making

The Government proposes to amend principle 1 (effective decision-making) to state that schemes with more than 5,000 members should have access to in-house investment expertise equivalent at least to one full-time staff member who is familiar with investment issues. This is intended to increase the resources devoted to supporting trustee investment decision-making.

Given the relatively limited amount of time trustees spend on investment decision-making (an average of less than 4 hours per trustee per year for all schemes and 9.4 hours for very large schemes), additional staff resources are important in supporting the investment decision-making. Trustees already recognise this in existing arrangements: of very large schemes, 93% already have part or full-time internal support staff, while internal support staff help trustees in making investment decisions in 48% of very large schemes.

Assuming the staff assisting with investment decisions are familiar with investment issues, up to half of the very large schemes would need to secure additional staff to comply with the revised principle. This number would be increased where schemes have to increase part time hours worked to meet the requirement of equivalence with one full-time staff member. It would be reduced in cases where schemes can adjust their mix of support staff or find an alternative way of complying with the intent of the principle (e.g., the trustees have additional investment skills and experience).

Balancing these factors, we estimate that between 40 – 50% of the 454 very large schemes would need to secure services equivalent to one full-time staff member. Were this to cost an average of £40,000 p.a., the estimated cost to the industry of this proposal would be between £7.3 - £9.1 million p.a.

Increasing trustee skill and expertise

The Government proposes to amend principle 1 (effective decision-making) to state that for schemes with more than 5,000 members, at least one-third of trustees and the chair should be familiar with investment issues (even where investment decisions have been delegated to an investment subcommittee). This revision is intended to provide a more specific expression to the overarching principle that trustees taking investment decisions must have sufficient expertise and appropriate training to be able to evaluate critically any advice they take.

It is possible that the incremental cost of this revision will be minor. The Pensions Act requires all trustees making investment decisions to be familiar with investment issues, unless investment decision-making is delegated to an investment subcommittee (in which case the subcommittee members must meet the standard). It is likely that in complying with the Pensions Act requirements, many very large schemes will meet the 'one-third plus chair' principle.

The Consensus research indicates that 65% of very large schemes already have an investment subcommittee. A proportion of these schemes will need to increase – perhaps by only one or two at most – the number of trustees familiar with investment issues. The 35% of very large schemes that do not have an investment subcommittee will need to ensure that all trustees are familiar with investment issues or form an investment subcommittee. Having met these requirements, only a proportion of these schemes will need to further increase the number of trustees familiar with investment issues.

A conservative estimate is that perhaps between 25% and 50% of very large schemes might have to increase the number of trustees familiar with investment issues. It is difficult to quantify the cost implications of this.

Three areas in which this might increase costs are payment of trustees, search costs for qualified trustees and training costs. However, schemes will use different mixes of services to achieve their goal and costs will fluctuate from year to year, reflecting uneven patterns of trustee turnover and the variable length of trustee tenure. If between 25% and 50% of the 454 very large funds were to increase their expenditure by an average of £15,000 p.a., the estimated cost to the industry of this proposal would be between £1.7 - 3.4 million p.a.

Contracting separately for asset allocation and manager selection advice

The Government proposes to amend principle 4 (expert advice) to state that funds should contract separately for strategic asset allocation and fund manager selection advice. This would provide a clearer focus on asset allocation activity and would allow more parties, including fund managers, to compete for the provision of asset allocation advice.

Feedback from the industry suggests that this separation of contracts is not widespread. This is supported by the Consensus research, which shows that only 15% of schemes currently have a specialist asset allocation adviser. Moreover, in three-quarters of these cases, this service is provided by a company related to the incumbent investment consultant and in more than half of these instances, the contracts were not tendered separately.

Similarly, competitive tendering for investment consulting services is not as widespread or frequent as might be hoped: 16% of schemes have never held a competitive tender and 15% did not know the last time a competitive tender occurred. Only 28% of schemes had held a competitive tender for investment consulting services in the past two years. Two-thirds of schemes have engaged their scheme actuary and investment consultant from the same firm; in only half of these cases were the contracts the subject of independent competition.

This data suggests that relatively few schemes already comply with the revised principle. It is consistent with the proposition that compliance with the revised principle will not be cost-effective for some funds – principally small ones – because it may be more efficient for them to purchase such advice as a bundle. Finally, the data suggests that uptake of the revised principle is likely to be a gradual process.

Complying with the revised principle is likely to require more competitions for contracts and increased legal and administrative costs associated with a greater number of contracts (albeit reduced in scope). These costs are not easy to estimate.

We estimate that up to two-thirds of the 6,699 pension funds covered by the Myners principles might find it beneficial to split out contracts for asset allocation and fund manager selection advice (this would achieve coverage of well in excess of 90% of scheme membership). Allowing for schemes which are already compliant, approximately half of schemes would need to put in place new arrangements. If this tendering process were to occur at four-yearly intervals at an average cost of between £4,000 - £6,000, the estimated cost to the industry of this proposal would be between £3.4 - £5.0 million p.a.

Conclusion The remaining revisions to the Myners principles[21] are not expected to have a cost impact on the industry largely because they simplify or restate existing principles, or require disclosure of current data through existing channels. The total estimated cost of revisions to the Myners principles at this stage is therefore estimated to be in a range of £12.3 - £17.5 million p.a. with a mid-point of £14.9 million.

Benefits

The benefits of the proposed revisions to the Myners principles are the same as those originally expected, namely an improvement in the quality of investment decision-making by pension fund trustees, flowing through into higher 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. However, it is not easy to demonstrate a connection between the impact of the proposed revisions on trustee governance and the resulting incremental improvement in investment returns.

The theoretical case for better governance leading to improved investment decision-making and thus superior investment returns is unambiguous. 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 of performance.

The empirical evidence is more mixed. Some studies have identified a positive correlation between indicators of good governance and the investment performance of listed companies. However, others fail to find linkages between archetypal good governance practices (e.g., having an independent board) and firm performance. Proving conclusively that such a linkage exists or does not exist is hard because of difficulties in defining and measuring good governance, and in isolating and allowing for the different drivers of performance.

The value of listed UK equities was £1,368 billion at end-2003, of which UK pension funds own 16%, with other UK institutional investors owning 32%. Improvements in investment decision-making which lead to value-enhancing decisions by companies

[21] See pages 35-37. The changes are to:

- principle 1 (effective decision-making) stating that the chair of the board should be responsible for ensuring that trustees taking investment decisions are familiar with investment issues and that the board should have sufficent trustees for that purpose;
- principle 5 (explicit mandates) clarifying the requirements that trustees and investment managers should agree clear timescales for performance measurement and evaluation;
- principle 6 (activism) to substitute the requirement for trustees to comply with the Institutional Shareholders Committee statement of principles rather than those of the US Department of Labor Interpretative Bulletin;
- principle 10 (regular reporting) stating that trustees should publish the results of monitoring their own performance, when they fulfil their commitment to publish the results of monitoring the performance of advisers and managers; and
- principle 10 (regular reporting) stating that key information sent to members should also be published on a fund website, and that it is good practice for funds with more than 5,000 members to have a website dedicated to the fund.

have the potential to increase the value of all shareholdings. If one assumes that all the benefits of improved investment decision-making are reflected as an increase in returns from listed UK equities, an improvement of 0.01 percentage points in the annual rate of return would generate £136.8 million. Alternatively, an increase of 0.0011 percentage points in the annual rate of return on the portfolio would generate £15.0 million, sufficient to cover the estimated mid-range cost of the proposed revisions to the Myners principles.

Small firms impact test

Small pension schemes and firms are not expected to suffer a disproportionate impact from the proposed revisions to the principles. Because the principles are voluntary best practice, smaller pension schemes can choose not to comply (and explain the reasons for this to their members) where the benefits would not exceed the costs or compliance would not be appropriate for other reasons.

In addition, the more specific of the Government's proposed revisions (providing numerical targets for staff resource and trustee expertise) will apply only to very large pension schemes, reflecting the fact that scheme size is relevant in determining the level of effort and resource needed to comply with the principles.

Competition

The proposed revisions to the Myners principles are not expected to diminish competition. In many cases, pension funds do not compete against each other but, to the extent that improved levels of trustee governance result in better performance, members are likely to see, if anything, an improvement across the range of pension options. Improved trustee governance, and some of the specific revisions to the principles (e.g., splitting contracts for strategic asset allocation and fund manager selection advice), are also likely to result in a more competitive environment for advisers and a potential increase in the number of competing suppliers.

Monitoring and review

The Government has just concluded its review of how effective the principles have been to date in achieving the desired behavioural changes. This shows growing acceptance of the Myners principles over the review period. The NAPF has agreed to undertake a further review in 2007 of the progress its members are continuing to make against the Myners principles, and put the results to Government. In light of the NAPF's evidence, the Government will assess the degree to which the principles have resulted in behavioural change and consider whether there still remains a need for further policy action, by the end of 2007.

Consultation

Within Government This review was managed by HMT, with input from the Department for Work and Pensions, the Department of Trade and Industry, the Office of the Deputy Prime Minister and the Occupational Pensions Regulatory Authority.

Public consultation The Government undertook an extensive survey to determine the extent of implementation of the Myners principles. This covered 1,580 of the 6,699 pension schemes estimated to be covered by the Myners principles. The detailed results were published in November 2003 and July 2004. The Government received submissions from, and officials met with, many interested parties informally during the course of the review. Ministers also held a series of informal roundtable seminars, involving trustees from public and private schemes, fund managers, investment consultants, academics, trade associations, government officials and the author of the Myners report.