NAPF
Securing the future of pensions

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Letter to Chris Hodge
FRC
Via Email

Dear Chris,

Review of the Effectiveness of the Combined Code Call for Evidence

The NAPF is pleased to contribute its thoughts to your Review and our answers to the questions you ask are appended to this letter.

By way of introduction, we would make the following points:

- Governance standards will inevitably be found wanting at some companies during a recession and a deep recession such as we are currently experiencing will reveal more weaknesses.
- This does not necessarily imply significant shortcomings on the part of most boards or poor oversight by shareholders, neither of whom is blessed with perfect foresight;
- Nor does it suggest that the Code is in need of a major overhaul.
- That said it is entirely appropriate that all parties involved in the governance of UK companies consider the lessons to be learnt from the crisis and modify their policies and approach as needed.
- Pension funds' own governance standards have come under scrutiny following the updating of the Myners' Principles in 2008. Principle 5 links directly into their role in supporting good standards of corporate governance.
- Good governance also requires high quality inputs and we would suggest that investors and companies alike would benefit from improvements in the voting process at company meetings.
- While conscious of the immense amount of work that has gone into the review of accounting standards and the work of the audit profession, we believe that both areas would benefit from further analysis in the light of the financial crisis.
- While "light touch regulation" has been discredited in the financial services sector, we note the growing burden of regulation on pension funds and oppose any suggestion that better governance oversight can be delivered through regulation.

Issues for Comment

Board balance, structure and independence have all been reinforced by the Code and generally work well. We note particularly the evolution of the role of the SID into a valuable contact point for shareholders. However, we cannot ignore the governance lessons from the bank failures and highlight below the need for better board evaluation processes and more scrutiny by shareholders of directors who are up for re-election. It is evident now that shareholders must be particularly vigilant where they are invested in complex businesses or ones which have a dominant CEO.

The so-called "**nine year rule**" remains a source of friction between shareholders and boards. The NAPF Corporate Governance Policy has recently given more prominence to concurrent tenure of executive and non-executive directors as a test of independence. The re-election of a director should not be a formality and shareholders should be prepared to withhold their support where there is doubt about the case for re-election.

We suggest that while the standard should remain, the Code's statements on succession planning and board effectiveness evaluation could be strengthened to provide better context for longer tenure as well as being an important disclosure in its own right.

We recommend that boards ensure that in the notice of meeting a detailed statement is made in support of a director's re-election.

Non-executive directors have an increasingly demanding role. It is important that the board has the right mix of skills and experience and that directors are provided with the appropriate resources to carry out their responsibilities.

The Code should encourage boards to make use of advisers as needed and to make appropriate disclosure in the annual report.

Another area of concern is **remuneration**. This is a complex area, but in short we believe that current practices serve neither shareholders nor management well and wish to see radical changes to them. While this is in part linked to the risk issues identified by the FSA, it is also to do with the long-term alignment of interests between shareholders and executives. We believe this can best be achieved through the outright ownership by management of meaningful numbers of shares in the company. Options and performance shares often serve to confuse, are probably undervalued by the recipients and thus fail to motivate effectively.

Our specific recommendations are that the Code should strongly advise against frequent benchmarking of pay and that performance-based pay should be largely in shares. Disclosure on remuneration policies, including the role of risk in setting objectives, could also be improved.

Audit and risk have attracted increased attention and, as in previous submissions, we emphasise the need for improved standards of transparency and accountability of the audit committee to shareholders. An advisory vote on its report at the annual meeting of the company is supported by a number of our members.

We are not aware of any parts of the Code which have reduced effectiveness and note recent studies which suggest that the balance of board meetings between compliance/governance and strategy/ business is now firmly towards the latter.

We are conscious of the risk that "more is less" so hesitate to recommend the introduction of new material to the Code, beyond the few adjustments covered here..

An effective **"comply or explain"** regime requires shareholders to have confidence in the board and equally for boards to recognise that in a few cases no explanation will suffice. It is therefore a demanding standard – and it should be. As acceptance of the Code's Principles has grown so investors' attitudes towards non-compliance has tended to harden. The onus is therefore increasingly on boards to provide better explanations when non-compliance is seen to be in the best interests of the shareholders. We believe there is room for improvement in the quality of disclosure at many companies.

Engagement over compliance with the Code has improved in both quantity and quality in recent years, but with excessive focus on remuneration (which is of course subject to a vote)

and too little on board effectiveness. The latter is patently more important in delivering long term returns. Shareholders and directors alike should spend more time evaluating the role the board has played in developing strategy and overseeing its implementation. There is room for improvement in reporting the results of engagement activity on the part of boards to their shareholders and investment managers to their clients.

We recommend that the Chairman and SID have specific responsibilities for ensuring that strategy is communicated to shareholders and that shareholders' views are fed back to the board.

Content of the Code

We have few specific comments on the content beyond the points made above. We repeat that it has, overall, proved to be effective in raising awareness of and promoting good governance practices. Recent events do not support the case for a material overhaul of its Principles or its guidance.

Many boards already recognise the importance of **risk management** and have incorporated it into the terms of reference of the audit committee or set up a separate risk committee. We expect more companies to take this route, while at the same time developing better standards of reporting on risk in the Business Review.

The **remuneration committee** clearly has an important role to play in setting a policy which supports the long term strategic objectives of the company and aligns the interests of management with those of long term investors such as pension funds. and therefore takes into account wider pay practices in the business, risk management and other factors. The Code already addresses these points and we have recommended above some strengthening of its language. It is also important that there is good communication between the three board committees. There is a significant overlap between their functions which can be overlooked and shareholders would benefit from more information about how each interacts with the other.

The role of **institutional shareholders** has been the focus of much attention, particularly since the Government's bail-out of some UK banks. It is important to recognise the limitations of UK institutional shareholders, who, it is estimated, now hold a minority of the UK market (pension funds own about 13%) and are by definition not insiders or management consultants. Their primary responsibility is to their clients who have employed them to generate returns out of which to pay pensions or to meet the expectations of savers. They will express their views on individual companies by buying, holding or selling their shares. The market, therefore, can deliver the most powerful message about investors' assessment of the effectiveness of a company's strategy. Boards and investors alike should take note of that message.

Section 2 of the Code has been less effective than perhaps hoped, partly for some of the reasons set out above. We would also distinguish between engagement of a more routine nature which is aimed at supporting compliance with the Code and engagement which has a more strategic intent. Neither the Code nor the ISC Principles make this distinction. The larger institutional investors in the UK are well equipped to handle the former and the standard of reporting to clients has improved markedly in recent years. We see little reason to seek changes here except to encourage collaboration in the interests of efficiency for both investors and companies.

Strategic engagement is substantially more difficult and time-consuming, but also required much less frequently. Institutional investors recognise that there is a need for improved collaboration, led by senior investors. Such a mechanism might also provide boards with a route for sounding out key shareholders on important strategic issues.

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Since the last update of the Code, the International Corporate Governance Network has published a paper on the responsibilities of shareholders, which has the support of many institutional investors.

The NAPF has for some time encouraged the incorporation of the ISC Principles into pension schemes' "statement of investment principles" and in its review of the Myners' Principles makes explicit reference to the importance of corporate governance. The challenge, particularly for all but the largest schemes, is to improve the monitoring and accountability of their managers for compliance. We see some signs of improvement here, but more needs to be done.

NAPF Case Committees continue to be available to assist members who wish to work together on engagement matters. We plan to improve their effectiveness in coming months.

Application of the Code

The "comply or explain" approach has worked in that it provides a flexible framework for the application of the Code's Principles which is well understood by most investors and companies and has led to good standards of governance across UK listed companies. From an investor stance our impression is that the concerns expressed in 2007 have decreased.

There remains a real issue around how to improve the quality of the dialogue between shareholders, with their varying objectives, and boards over strategy. We believe that the answer lies in part in more collaborative efforts by institutional investors which is a key recommendation of the Institutional Shareholders' Committee's paper on governance and the banking crisis. That apart it is our intention shortly to explore with company directors and investors what practical steps we can take on behalf of our members to make engagement more effective for all involved.

Yours sincerely

David Paterson
Head of Corporate Governance