Securing the future of pensions

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Mr Grant Kirkpatrick
Senior Economist
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Via Email

Dear Mr Kirkpatrick

Organisation for Economic Co-operation and Development - Public Online Consultation on Corporate Governance and the Financial Crisis

The NAPF is the representative body for the UK's occupational pension schemes and as such has taken a close and continuing interest in all matters which affect the ability of its members to oversee the assets under their control. In particular, we have been active participants in the development of improved standards of corporate governance in the UK and in the reform of company law over many years.

We welcome the ongoing work of the OECD as a global standard setter and are pleased to provide the attached response to the recent questionnaire.

Yours sincerely

David Paterson
Head of Corporate Governance

OECD

Issues for Consultation
Governance of Remuneration

 What are the most important features of a well governed process for deciding on compensation in a company? Which should be the role of shareholders in this process?

- *A clear link to long term business strategy as determined by the board and communicated to shareholders, to ensure proper alignment of rewards and business success. Alignment of rewards with business success requires a focus on ensuring that the timescales for executive reward marry with the interests of customers and shareholders, and incorporate a measure of risk. Executives should not be rewarded for apparent temporary positive performance which is ultimately destructive of the business and shareholder value.*

  Delegation of strategy formation to a committee comprised solely of independent directors who have access to independent advice as needed. Employment contracts which specifically rule out guaranteed payments above a basic salary and any statutory entitlements. Large shareholders should be consulted about remuneration strategy and ideally all shareholders should be involved through full disclosure of the policy in the Annual Report and an advisory vote at the annual meeting.

 What are the main risks associated with performance based compensation? How can they be identified and taken into account?

- *The main risks lie in the behavioural responses to performance pay and thus the role of senior executives in setting standards and defining corporate culture cannot be emphasised enough. Inappropriate behaviour should be discouraged at all levels of the business through a strong code of ethics, with appropriate sanctions, including withholding performance pay and clawback. Total pay should have an appropriate balance between fixed and performance pay with incentive pay only paid out as a result of clear value-creation over an appropriate measurement period. We believe that the remuneration committee should as part of its disclosures assert that remuneration structures across the organisation match with the intended corporate culture. The committee should also explain the interaction between its own work and that of the audit and nomination committees, or their equivalent.*

 Should risk managers and the boards' risk management function be formally involved in the design of compensation schemes?

- *Risk management is being asked to play a more central role in overseeing a business and as noted above risk should be taken into account when setting remuneration policy. However, while the risk management function should assist in informing the board of risk issues we see to advantage in its formal involvement in compensation.*

Implementation of Risk Management

 What is the most important step a company can take if it wants to improve its risk-management system?

- *The audit committee and the non-executive directors generally need to take ownership of risk matters, to have proper resourcing and support to enable them to carry out the role appropriately. It is for them to draw the risk management function* *into a direct dialogue with them, rather than for the risk management function to be pushed up to meet them.*

 How shall the internal governance structure be designed to support active and effective implementation of risk-management throughout the company?

 What are the respective roles and responsibilities of the board, board committees, auditors, key executives, employees and other that may be involved?

- *The non-executive directors as a whole and particularly the audit and risk committees where these exist need to generate a culture of openness and trust regarding risk management issues. They need to take ownership of the key risks which the company faces and consider the effectiveness of the way in which these are managed and mitigated. To enable them to do this, they need appropriate resourcing and information. At a minimum, this will require a direct dialogue with internal audit and the risk management function; the head(s) of these functions should have a soft reporting line to the chair(s) of the audit and risk committee(s), and their appointment and removal should only occur with the approval of those committee(s). In a similar way, there should be an open and honest dialogue with the external auditors. Shareholders would welcome clearer and fuller disclosures of these structures and approaches in annual reports to build confidence in the company's approach.*

Board Practices

 What is the main lesson from the fact that boards have been unable to direct their companies away from important meltdowns? Is it just a matter of competence or have companies become too large and complex to allow effective board oversight?

- *Size and complexity mean that no single person can be expected to understand a company in detail. But size also brings benefits for shareholders and mistakes need to be distinguished from “meltdowns”. Boards need to be staffed with the right mix of experience and expertise to address complexity and directors need to ensure that the information provided to them allows them effectively to challenge management on strategic issues. Directors will from time to time benefit from outside independent advice (eg on remuneration) and this should be explicitly recognised in the board’s terms of reference.*

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What needs to be done to restore the confidence in the board of directors as a key pillar in corporate governance? Shall legislators and standard setters try to regulate further the composition, qualifications and size of boards in public companies?

- *Additional regulations should be avoided for most companies (banks may be an exception). Boards need to be more questioning of their own skills and more open in their assessments. Non-executive directors have a difficult job to do at the best of times and should consider what additional skills are needed to carry out their responsibilities effectively. Directors should stand for regular re-election, at least every three years, and their candidacy should be fully explained to shareholders in the notice of meeting.*

  Institutional investors also have an important role in holding boards to account through regular and informed dialogue which is reported back to the board as a whole. The effectiveness of such engagement should be assessed by the investors who should report to their clients as part of the fulfilment of their mandate.

Exercise of Shareholder Rights

What role did large institutional shareholders play in the financial crisis? In their role as investors and in their role as owners?

- *The NAPF is of the view that the principal failure leading to the financial crisis was one of regulatory oversight. Its members as longer term investors (with only a small interest in so-called hedge funds) would see their role as investors and owners coinciding. In the UK most managers of pension assets are vocal supporters of the Combined Code and use their votes to support its principles. With hindsight they might have been more critical of some financial institutions' business strategies, but such reservations as were expressed were it seems ignored by boards.*

  There are clear lessons to be learnt from this experience: the need to co-operate more extensively and effectively; improve the quality of dialogue; and a recognition that change takes time and persistence.

Would additional shareholder rights have changed anything in terms of their ability or willingness to monitor CEO's and boards?

- *As rights vary considerably across different countries, there is no simple answer. However given the central role of the US economy it should be asked if shareholders have sufficient rights there properly to hold management to account. We note the flawed director election process and the lack of accountability on remuneration as two issues which have received much coverage in the press. US system also lacks the power to requisition meetings which is possible in the UK (and elsewhere) where it is rarely invoked but can be used to remove and appoint directors as well as transact other business. Again the very existence of this power despite its rare use puts shareholders in a stronger position and may encourage directors to engage more meaningfully. The shareholder proposal with the low threshold of ownership to put a non-binding resolution on the ballot is a positive feature of the US system and sometimes encourages engagement but it should not been as an alternative to more meaningful powers to hold directors to account.*

 In terms of their own business model, incentives and governance structure, what is the most important obstacle to more active and informed ownership by institutional investors?

- *There is excessive focus on asset gathering and pressure to meet short term performance expectations at the expense of the longer term interests of existing clients. Active and informed ownership is labour intensive and asset owners such as pension fund trustees (who normally have long term liabilities) therefore need to make it clearer to their asset manager intermediaries that this is a priority.*