PIRC

PIRC RESPONSE / MAY 2012

Treasury committee inquiry into corporate governance and remuneration: PIRC response

The voice of responsible shareowners

We welcome the opportunity to submit evidence to the inquiry. Pensions & Investment Research Consultants Ltd (PIRC) has been an independent adviser to pension funds and other institutional investors for over 20 years. PIRC's clients have combined assets in excess of £1.5 trillion and include some of the largest pension funds, asset management companies and insurance companies in the UK and overseas. Together, they comprise a diverse group of institutional investors with long-term liabilities and broad fiduciary duties.

PIRC undertakes company research on corporate governance and corporate social responsibility issues at public companies, and provides advice to clients on proxy voting strategies and other active shareowner initiatives. Our comments are based on two decades of practical experience, which inform our views on the strengths and weaknesses of disclosures, governance structures, and the interaction of statute, regulation and codes of practice.

PIRC'S RESPONSE TO THE INQUIRY

Response to specific questions

Please note we have only answered those questions where we have a particular view.

Board structure and composition

What outcomes should corporate governance in the financial services sector seek to achieve?

We believe that John Kay has identified the appropriate focus for such firms in the light of the global financial crisis:

"The purposes of equity markets are to generate returns for savers and to improve the performance of companies. In the long run, returns to savers will be equal to the returns earned by companies, less the costs of intermediation. There is a fundamental alignment between the success of companies and the returns to savers."[1]

In this context we believe that financial services firms should be considered in a similar framework in that their public company status requires them to behave as if the long term really mattered and that their responsibilities to shareholders entail appropriate obligations to their clients and customers.

Are Board structures effective? For example, should UK financial institutions consider adopting alternatives to the unitary Board structure?

There is a danger that the UK oversells the benefits of a unitary board, as two-tier boards seem to work perfectly well for many non-UK companies. However it is also clear that companies with two-tier boards have failed in the crisis.

Perhaps the best lesson that the UK can learn in this respect is to acknowledge that other models are valid, and that convergence on the model of the unitary board, and no stakeholder representation, is neither a given nor inherently desirable. The nature of stakeholder representation through the two-tier board structure in different markets is particular (for example between the German model, the Dutch model and the Danish model) and therefore continued study through comparative analysis should be requested by HMT and BIS.

Does the UK approach to regulation and supervision of financial services incentivise Boards to perform their role effectively? Is more intrusive regulation a substitute or complement to effective corporate governance? Is a "comply or explain" approach an effective framework for governance?

Again we note that much commentary from within the UK's governance community asserts the value of 'comply or explain' in contrast to regulation, though typically with little or no evidence to back this. PIRC has publicly stated that we believe that certain elements of corporate governance might be better dealt with through regulatory intervention than market oversight, particularly where there is clear agreement.

What benefits, if any, come from EU regulatory engagement with corporate governance issues?

Whilst we note that many in the UK have a negative attitude towards the EU's involvement, it is worth noting that in some areas more searching questions have been asked by the EC than in the various analyses provided by bodies in the UK, where such analysis has been conducted (eg FSA reports). We would particularly highlight the EU consultation on audit quality, which proposed interventions that go significantly further on issues relating to auditor independence than have been entertained by UK

[1] The Kay Review of Equity Markets and Long-term Decision Making, Interim Report, February 2012

policymakers. We believe that the UK has been particularly weak in this area historically, and European intervention may deliver positive benefits for shareholders.

What impact has the Walker Review (2009) had on corporate governance and corporate behaviour in financial services?

The Review essentially worked within the existing framework of UK governance and has strengths and weaknesses because of it. Whilst the recommendations on remuneration disclosure – particularly below board level - were welcome, PIRC believes it missed the opportunity to dig into the questions of scale of reward, and the motivational value of performance pay.

Similarly, the Review's consideration of other approaches to governance, such as some level of stakeholder representation, was rather perfunctory. Such a study is overdue.

The Review played an important role in highlighting the role of shareholders in the governance of financial institutions, and ultimately led to the development of the Stewardship Code. Whilst we consider that the Code has weaknesses, we believe it has in general been a positive development.

Non Executive Directors

Should non-executive directors bear greater liabilities than under current law?

We believe that an independent assessment of the role of directors following the passage of the section of the Companies Act 2006 relating to directors duties would help contribute to the question of whether greater legal liabilities are required.

Should executives in FTSE 100 companies be able to hold non-executive positions in other firms?

In our experience executive directors facing multiple active directorships (in both corporate and non-corporate) organisations suffer from a lack of focus in their principal responsibilities at some time or other. It would be a prudent requirement to limit membership by executive directors to one other FTSE100 company board as a non-executive.

The role of shareholders

Should shareholders be required to exercise a stronger role in systemically important financial institutions? What are the key barriers to greater shareholder activism by institutional investors in financial institutions? What risks are associated with it?

We believe that shareholder oversight of systemically important financial institutions continues to face challenges. At the end of 2009, PIRC undertook an analysis of voting trends amongst asset managers invested in the UK-listed banks. This was based on the voting data publicly disclosed by asset managers. We found that shareholder challenge, as expressed in votes against and abstentions, was limited prior to the crisis, although there was evidence of change in 2009.

In the course of responding to the inquiry, we have undertaken some further analysis of voting trends looking at the period from 2008 to 2011. Some surprising findings included that –

- In 2011, there was an increase in support for banks' remuneration reports from the sample of asset managers analysed. The level of opposition was only lower in 2008.

- There were five asset managers that voted for all the banks' remuneration reports in 2011, compared to four in 2010 and none in 2009.
- Looking at 2011, we were able to identify two abstentions and one vote against a director of a bank facing re-election, out of a total of 709 voting decisions captured.
- In comparison in 2009, we were able to identify seven abstentions and eleven votes against a director of a bank facing re-election, out of a total of 692 voting decisions captured.
- In the four year period we were only able to indentify two instances of votes against the re-appointment of the auditor, out of a total 313 voting decisions by 20 asset managers captured. Both cases involved the same manager opposing auditor appointments in 2011.

The apparent increase in support for bank remuneration policies, at least within the sample analysed, is consistent with some anecdotal market feedback. PIRC believes that some asset managers were wary of "bank bashing", and accepted the argument made by the banks themselves that too much shareholder pressure on remuneration might be counterproductive.

Looking at the limited challenge to incumbent directors in 2011 compared to 2009, this might in part be explained by the fact that new management teams had been established, and investors were wary of destabilising them. These findings should also be seen in a context of an extreme reluctance on the part of asset managers to vote against directors generally.

The lack of challenge to audit firms is puzzling, since the firms that were reappointed without challenge had typically signed off the accounts of the banks on a 'going concern' basis in 2008, only for those banks to require recapitalisation to survive a few months later.

We note that the committee's previous inquiry into corporate governance and pay in the City stated: "We are perturbed that the process results in 'tunnel vision', where the big picture that shareholders want to see is lost in a sea of detail and regulatory disclosures." [2]

PIRC believes shareholders must take a more active role in audit and accounting issues, and that the absence of such investor involvement at the banks pre-crisis was a significant failure of oversight.

More generally, events so far in 2012 suggest that in the current AGM season a number of UK asset managers have toughened their voting stance at UK companies, including the banks. Barclays saw significant votes against both its remuneration report and the chair of its remuneration committee. It is not immediately apparent what has caused this upsurge in dissent, but political pressure must have at least some role. In addition, it is worth noting that the so-called 'shareholder spring' has gained prominence because investors have begun to use their voting rights more assertively. PIRC therefore believes that it is important that the Government, and bodies such as the select committee, continue to focus on the role shareholders can play, and the importance of them using their voting rights effectively.

Is it realistic to expect sovereign wealth funds and hedge funds to undertake a more active role?

Yes, we believe there is nothing inherent in the nature of either sovereign wealth funds or hedge funds that would prevent them playing a more active role. Indeed in our own experience have found that both types of investor can provide a more critical perspective. It is unfortunate that the UK's corporate governance community has been

[2] http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf

dominated by traditional institutions and their trade bodies which have historically exhibited a very passive attitude to ownership issues.

Remuneration

What role should institutional investors, remuneration consultants, employees and others play with respect to remuneration in the financial services sector?

Presuming that there is no desire for further regulatory intervention in respect of remuneration, then the only other two groups likely to provide effective oversight of remuneration in public companies are their shareholders or their employees. In the UK governance model employees are not currently afforded any specific role, although PIRC has long supported that they should have representation on remuneration committees.[3] As such it must fall to shareholders to be the principal groups exercising oversight.

Unfortunately in recent history most asset managers as the largest group of those owning shares in UK companies have been very reluctant to oppose all but a small minority of remuneration-related proposals. The large votes in favour that most financial institutions have received have served only to legitimise rent capture by the executives running them. Of particular concern is the attitude of some asset managers which downplay the value of voting, and which often vote in favour of controversial proposals whilst expressing concerns privately. PIRC believes such an approach is still employed by some houses, and has the effect of distorting the signalling function of voting. The market receives the impression that all is well even when there are concerns.

Therefore we believe an important message that the Government and others can send is that shareholder voting rights are valuable, and must be used to challenge companies where there are concerns. It should be a simple principle that if shareholders disagree with a proposal then the assumption will be that they will vote against it, unless there are very compelling reasons not to do so. It is regrettable that such a basic principle requires articulation, but nonetheless we believe that the promotion of such an attitude would be beneficial.

In respect of remuneration consultants, it must be clear that they work for the remuneration committee, not for the company, and the firm employed should not undertake other work for the company or company employees. In addition we would favour remuneration consultants being subject to a shareholder approval vote, as is the case with audit firms.

Is there a case for introducing still greater transparency for senior executives with respect to remuneration in the financial services sector?

We are not opposed to further transparency, but it is important to be realistic about what it may achieve. It should not be assumed that further disclosure of remuneration arrangements, for example below board level or further down the organisation, will necessarily lead to more accountability (for example to shareholders). However such disclosure may be a public good in making more transparent the level of reward available within one particular sector of the economy.

Should there be further reform of the remuneration arrangements of senior executives in the financial services sector? Should this extend to those highly paid individuals who sit below executive level?

We agree with the proposal in the Walker Review that below board level remuneration should also be more transparent, particularly where individuals working in particular business units are generating significant proportions of a financial services firm's income, eg proprietary trading desks.

[3] http://www.pirc.co.uk/news/pirc-calls-nudge-remuneration-committees

However there is a danger that the post-crisis reform effort puts too much emphasis on the design and structure of remuneration as opposed to its scale and motivational value. PIRC believes that the excessive emphasis on performance-related pay adds to complexity, which makes it both harder for shareholders to exercise oversight and less likely that recipients will be motivated by the schemes. All parties in corporate governance agree that too much time and resource is devoted to remuneration issues, yet this is an inevitable consequence of numerous attempts to redesign rewards.

PIRC is increasingly sceptical that performance-related pay has provided benefits to either shareholders or companies, and we note that opinion within the remuneration consulting industry is moving in this direction too.[4] The one reform we would advocate is radical simplification of pay schemes – stripping back remuneration to salary and at most one, simple, incentive scheme.

What is the relationship, if any, between Board diversity and company performance in the financial service sector?

We believe that this area of study is considerably under researched. We commend the TSC to call for independent evidence from the BIS on this matter.

[4] http://pwc.blogs.com/northern-ireland/2012/05/complex-pay-deals-dont-motivate-top-management.html

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