

*Professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgement, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practise the fourth, fifth and higher degrees...*

*It is the long term investor, he who most promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks. For it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.*

*J.M. Keynes, The General Theory of Employment, Interest and Money, 1936.*

# Institutional Investment in the United Kingdom: A Review

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6 March 2001

*Dear Chancellor*

Institutional investors – in particular, pension and life funds – now manage the savings of millions of people. They also ‘own’ and control most of British industry. They have come to play a central – if low-key – part in our national economic life.

Unlike some, I do not see these trends as sinister or unhealthy. On the contrary, I regard our strong funded pensions system, our highly-developed equity culture and the professionalisation of investment in the UK as key national assets. That is certainly how they appear, rightly, from the perspective of many other countries of Europe.

Nevertheless, we need to be clear that the savings industry, and the decision-taking structures we have evolved over the years, face forbidding challenges. The population is relentlessly ageing. The labour market is unrecognisably different. So, partly in consequence, are employer attitudes. These are the reasons why I think now is the right time to go over the ground covered by this review. We need to be certain that our structures are up to an environment in which the typical employee now changes jobs repeatedly over a lifetime, and must provide for the possibility of literally decades of retirement.

In the world we now face, an ever-higher premium is likely to be placed on *efficiency* and *flexibility*. The review’s conclusion is that our present structures fall short on both counts. In short, it finds that savers’ money is too often being invested in ways that do not maximise their interests. It is likely to follow too that capital is being inefficiently allocated in the economy.

The review therefore sets out a blueprint for change. At the heart of it is the belief that clearer incentives and tougher customer pressures need to be driven throughout the savings and investment industry.

## The review’s analysis

A number of points from the analysis stand out:

- at the heart of the system, we often make wholly unrealistic demands of **pension fund trustees**. Our legal structures put them firmly centre-stage. They are being asked to take crucial investment decisions – yet many lack either the resources or the expertise. They are often unsupported by in-house staff, and are rarely paid;
- as a result, we place a heavy burden on the **investment consultants** who advise trustees. A tiny group of providers, mainly actuarial firms, dominate this small and not particularly profitable market. The result, despite these firms’ best efforts – to which I pay tribute – is a narrow range of expertise and little room for specialisation. Nor is the consulting firms’ performance usually assessed or measured;
- a particular consequence of the present structure is that **asset allocation** – the selection of which markets, as opposed to which individual stocks, to invest in – is an under-resourced

activity. This is especially unfortunate given the weight of academic evidence suggesting that these decisions can be critical determinants of investment performance;

- the review is struck by lack of **clarity about objectives** at a number of levels. Fund managers are being set objectives which, taken together, appear to bear little coherent relationship to the ultimate objective of the pension fund, namely to meet its pension obligations;
- many objectives are set which give managers unnecessary and artificial incentives to **herd**. So-called “peer group” benchmarks, directly incentivising funds to copy other funds, remain common. And risk controls for active managers are increasingly set in ways which give them little choice but to cling closely to stock market indices, making meaningful active management near-impossible;
- there is also extreme vagueness about the **timescales** over which fund managers’ performance is to be judged. This is a real – but wholly unnecessary – cause of short-termism in fund managers’ approach to investment. More generally, the review is clear that fund managers remain unnecessarily reluctant to take an **activist** stance in relation to corporate underperformance, even where this would be in their clients’ financial interests;
- finally, an important cost to pension funds, namely **broking commission**, is subject to insufficient scrutiny. Clearer and more rigorous disciplines could be applied to these costs, which are substantial.

Private equity, an asset class the review was specifically asked to address (and on which it makes some specific recommendations) is in an important sense simply one victim – albeit an extreme one – of these deeper weaknesses in the investment process.

The review also looked at life funds. In principle, competition in the life industry – which can be intense – ought to drive efficient capital allocation. In practice, the review finds that investment performance is far from the main focus of competition in the industry. This has important implications for investment decision-making. But it also raises broader issues which fall beyond the direct remit of this review, and which I propose the Government should investigate separately. They are of central importance, given the important role the life industry plays – and is likely to continue to play – in the provision of defined contribution pensions in the future.

## Proposed approach

The problems the review describes are complex. They are essentially to do with incentives and behaviour.

Diagnosis of such problems is easier than cure. I do make a number of suggestions for legislative and tax change. I propose that trustees should, as in the US, have a legal requirement to be familiar with the issues when they take investment decisions. I propose replacing the Minimum Funding Requirement, which distorts investment and fails to protect scheme members, with a long-term approach based on disclosure and openness instead of an artificial uniform yardstick.

But I do not suggest that these alone are enough. Further change is needed. My strong preference, however, is for the industry – if it is willing – to drive change forward itself. Legislation, though it might in the end prove necessary, is likely to be a blunt instrument to tackle the kinds of problem I have described.

The review therefore believes it is important at least to attempt to seek an effective approach which does not rely on direct Government intervention in banning or directly determining behaviour. The approach I have in mind is consciously based on the precedent of the Combined Code of the Committee on Corporate Governance and the various codes that preceded it.

Such codes can be (and have been) criticised, for lacking teeth. In fact I believe history suggests otherwise. The voluntarist approach, allied with transparency, may not appeal to the purist. It cannot deliver

perfection. Nevertheless, corporate governance practices in this country are unrecognisable from the pre-Cadbury world. On any reasonable analysis, these codes have done their job.

I believe it should be possible to apply a parallel approach to pension funds and other institutional investors, and that such an approach could be a proportionate response to the problems the review describes.

The review has therefore set out, Cadbury-style, some basic principles of an effective approach to investment decision-making. These are to be found in Chapter 11. They occupy just two pages. The review's proposition is not that any fund should be *required* to comply with them; simply (as with Cadbury) that where a fund chooses not to comply with them, it should have to explain – publicly, and to its members – why not.

I recommend that the Government should consult on the detail of the principles and then promulgate them. The obligation to disclose against them could – and if necessary, I believe should – be imposed by the Government. However my strong preference would be for the industry voluntarily to adopt them, if it is willing.

To some, the principles may seem surprisingly basic. In a way they are – yet they certainly do not describe the status quo. Were pension funds and other institutions to adhere to them, substantial change in decision-making behaviour and structures would be implied. It is precisely that change that is the potential prize.

## Acknowledgements

I would like to thank the many people and organisations in the financial community who contributed to the work of the review. I received over 200 submissions to the consultation document, many of which had clearly required a considerable investment of resources by the responding organisation. Many also went on to give generously of their time to the review by attending meetings and workshops, and by providing data and information. I believe that the analysis of the review is much the stronger for their co-operation and support, and I am extremely grateful for it.

I would also like to thank the Secretary to the Review, Daniel Oppenheimer, and his team for the perception, clarity and commitment which they brought to the work of the review.

*yours sincerely*  
*Paul Myers*

# Summary

## ***Remit of the review***

1. In the 2000 Budget, the Government made clear its concern that there may be factors encouraging institutional investors to follow industry-standard investment patterns which focus overwhelmingly on quoted equities and gilts and avoid investing in small and medium-sized enterprises and other smaller companies.
2. It therefore commissioned this review to consider whether there were factors distorting the investment decision-making of institutions.

## ***Purpose of the review***

3. The review does not seek to argue that the institutions whose investment behaviour it examines have some public interest responsibility to invest in certain ways. But it is a legitimate issue of policy concern to establish the extent to which institutions' approaches to investment decisions are:
  - rational;
  - well-informed;
  - subject to the correct incentives; and
  - as far as possible, undistorted.
4. UK institutional investors own more than £1,500 billion of assets – over half the quoted equity markets. This very large pool of assets is of public policy interest for several reasons:
  - it represents the savings of millions of people. The ability of institutions to invest these assets effectively has a profound impact on their economic well-being;
  - successive governments have shaped the development of institutional investment: the favourable tax treatment given to various forms of institutional investment has been a very important factor in its growth; and
  - the decisions of UK institutions play a critical role in the process of allocating capital within the economy. This in turn is a key determinant of productivity and economic growth.
5. The review also has a specific remit to investigate institutional investment in private equity, but its purpose in doing so is to determine whether there are unnecessary barriers to such investment which should be removed, not to promote such investment regardless of whether it is right for the institution concerned. Indeed, a sudden move by pension funds to increase their allocation to private equity without proper consideration and analysis would be both damaging to them and contrary to the spirit of the review's recommendations. Private equity requires a sustained long-term approach, not rapid entry and exit driven by short-term performance results or changing fashion.
6. Nor does the review set out to encourage institutions to take on 'more risk'. As many respondents pointed out, UK institutions have shown a relatively high appetite for risk in the form of quoted equity investment. The issue is not their willingness to take on risk, but whether, as the evidence suggests, they have a preference for certain kinds of risk over others

that reflects sub optimal decision-making. The review does not seek to promote a particular asset class, or range of asset classes, for pension funds or other institutional investors. On the contrary, the review concludes that greater diversity of asset allocation policies would be desirable.

7. The review starts from the assumption that well-functioning markets generally deliver effective investment decision-making, allowing capital to be drawn towards strategies that produce higher risk-adjusted returns. Ultimately, this ensures that capital is efficiently allocated. The onus is therefore on policy-makers who seek to justify intervention to prove that the market in question is not functioning well.

### ***Types of institutional investors***

8. The principal institutional investors are occupational pension funds, which account for £800 billion of assets, life insurance companies, with almost £1,000 billion, and pooled investment vehicles, which are a smaller category.
9. For each group, the review seeks to understand in turn:
  - who is taking which decisions;
  - what their incentives are; and
  - what skills and knowledge they bring to their role.

### ***Pension funds***

10. Most occupational pensions are organised on a trust basis, with a board of trustees responsible for the determining how their assets are invested. As a survey conducted for the review confirms, many trustees are not especially expert in investment.
  - 62 per cent of trustees have no professional qualifications in finance or investment;
  - 77 per cent of trustees have no in-house professionals to assist them;
  - more than 50 per cent of trustees received less than three days' training when they became trustees;
  - 44 per cent of trustees have not attended any courses since their initial 12 months of trusteeship; and
  - 49 per cent of trustees spend three hours or fewer preparing for pension investment matters.
11. This is not true for all pension schemes, however. Larger schemes are more likely to have the resources to recruit and train more knowledgeable trustees, and the use of professional trustees has grown in recent years. But generally speaking, pension fund trustees, whether of defined benefit or defined contribution schemes, are able to bring limited time and expertise to the investment decision-making aspects of their work.
12. This should not come as a surprise. The priority of pensions legislation is to ensure that trustees run pension schemes in the best interests of the scheme members. This means ensuring that members' interests are not damaged by gross incompetence or mismanagement by the trust. The legislation generally achieves this, and it is effective in preventing the worst sorts of mismanagement. But although the legislative framework is consistent with rational and well-informed decision-making, it does not itself produce it. There is no legal requirement for trustees to have any particular level of expertise in investment matters, only that they 'obtain proper advice' about it.

13. The result is a heavy responsibility on the in-house staff of the fund, and on the fund's investment advisers.

### ***In-house staff and relationship with the sponsor***

14. In-house staff are a potential source of support for trustees. But they have greatly reduced in number and skill, as investment management has been increasingly outsourced. In part, this reflects the development of funds' relationship with their sponsor companies.
15. In principle, the sponsor of a pension scheme should be a natural source of support for the fund. It has some financial and investment expertise; more importantly, it has the resources to purchase more. At the same time, its commercial incentives are essentially aligned with those of the scheme: the more effective the investment decision-making of the fund, the more cost-effectively the sponsor can provide pensions to its workforce. Unfortunately, there are barriers which prevent the realisation of the sponsor's full potential to provide support.
16. First, UK trust law – under which the majority of schemes are established – makes a pension scheme a separate legal entity from its sponsoring company, encouraging an arm's-length approach. The thrust of UK pensions legislation and policy over the past ten years has reinforced this effect, heavily influenced by the Maxwell affair. There is an unspoken assumption that involvement by the sponsor is likely to be at the expense of members' interests and should therefore be regarded with some suspicion.
17. Second, there is a historical trend among UK companies to view pensions as primarily a human resources issue. One indirect consequence of this is often to place primary responsibility for pensions issues with the human resources function of the sponsor. This can leave the finance function only partially involved in management of the pension fund.
18. Third, while pension fund surpluses which built up in the 1980s were common for a time, and many companies were able to take contribution holidays, actually paying out the surplus from the fund to the sponsor has been difficult and liable to provoke litigation. It has also been subject to a discouraging tax treatment: while companies can benefit from surplus through contribution holidays, payment of any surplus to the employer is directly taxed at a higher rate. The result is an important asymmetry: sponsor companies bear the full cost if things go wrong but are very unclear about how much of the benefit they will receive if things go well. It seems likely that this has been a factor in the decline of defined benefit provision. More importantly for this analysis, it has meant that sponsor companies' incentives in relation to pension fund investment are distorted.

### ***Relationship with investment consultants***

19. Many respondents argued that the use of advisers dealt satisfactorily with trustees' lack of investment understanding. Respondents likened this to other instances of non-experts taking key decisions on advice from experts: company boards, for example, taking professional advice from lawyers, accountants or other advisers. According to this view, trustees are taking a decision they are competent to take – stating their risk appetite – by instructing investment consultants to present to them the risks of various investment strategies and selecting one with a level of risk with which they feel the greatest comfort.
20. The review is not reassured by this view. First, it plays down the problem that arises when decision-makers are so heavily dependent on advisers. No one in this situation has a clear mandate for taking decisive action or changing direction: trustees tend to feel that they lack the expertise to do so, and advisers that they lack the power to make decisions. The result can easily be inertia.



21. Investment in private equity by pension funds is probably an example of this. Trustees have tended not to consider investing in the asset class because it was not raised as a possibility by their advisers, and advisers in turn say that they have not recommended investment in private equity because trustees have not been interested in it.
22. Second, it is not clear that pension fund trustees can so easily be compared to most other instances of non-experts using advice to help take important decisions. Investing the assets is one of trustees' most crucial and frequently exercised responsibilities. One would not for example expect to find a board of directors of a pharmaceutical company with no scientific qualifications and no experience of R&D, arguing that this was not a problem as they took advice from a firm of expert scientific consultants. They would certainly take advice and there would be directors who lacked R&D experience, but collectively, the board would have the experience and skills to challenge the advice received at a sophisticated level.
23. The review believes that advice alone is an inadequate basis for decision-making, if trustees are not in a position critically to examine the information on which it is based.
24. This problem is particularly striking given the nature of one of the investment consultants' main tools: the stochastic asset-liability model. Asset-liability modelling is a complex number-driven process, in which it is difficult to incorporate asset classes without reasonably long historic time series data. The outcome of such a process is unlikely to be investment in new or poorly researched asset classes, such as private equity. Yet according to investment theory, it is precisely among poorly researched asset classes that greater opportunities for enhanced return are likely to exist.
25. More importantly, the outcome of the asset-liability modelling process depends crucially on a number of prior decisions and qualitative judgements, such as assumptions about rates of return and other economic indicators, and the division of assets into classes (an imprecise art, with elements of arbitrariness).
26. Research suggests that among schemes using an asset-liability model, trustees were involved in the setting of these underlying assumptions in only 30 per cent of cases. So although in law trustees are making the strategic asset allocation, in practice, there must be considerable doubt over the extent to which they are exercising genuine decision-making power.
27. Concerns over this lack of clarity about decision-making responsibility are reinforced by the nature of the investment consulting industry.

### ***The investment consulting industry***

28. The investment consulting industry in the UK is small and highly concentrated, with low levels of customer switching. However, there is no evidence of high profit margins in the industry, which led the review to conclude that there is no cause for conventional competition concerns. There are, however, wider policy issues.
29. As the analysis above shows, investment consultants are highly influential in investment decision-making. Moreover, the range of issues on which they give advice is broad and complex. They inform trustees about the risk and return characteristics of the various types of marketable securities, as well as alternative asset classes – and often also make manager recommendations for each.
30. Clearly, advising trustees successfully across these various issues involves a diverse range of specialist expertise. For all the best efforts and professionalism of the firms involved, a small

market composed of a limited number of long-established firms of similar backgrounds is unlikely to deliver everything that is required.

31. New and alternative asset classes such as private equity and hedge funds raise particular difficulties. The sources of advantage are more complex, and the distributions of returns much wider than in more efficient markets.
32. An important factor driving the structure of the investment consulting industry is the low level of resources committed to asset allocation by pension funds. They typically pay considerably more to have their securities portfolios actively managed than for asset allocation advice. Yet academic studies suggest that asset allocation plays a crucial role in determining investment outcomes. Clearly there cannot be a simple correlation between the importance of a decision and the level of resources and attention it attracts. But a willingness by trustees to commit more resources to asset allocation could lead to greater intellectual diversity and more specialist expertise in the approach of investment consultants to the issue.
33. There is surprisingly little assessment or measurement of the impact and effectiveness of investment consulting advice, either on asset allocation or manager selection. This is a problem in its own right, but also goes some way towards explaining the current industry structure. It is difficult to persuade trustees that they should spend more and make use of a wider range of investment consulting advice, if they have no means of assessing its effectiveness.

### ***Pension funds: two approaches to investment***

34. For the purposes of this review, investment decision-making for pension funds divides into two principal approaches.

#### ***Approach 1: the balanced mandate or managed fund***

35. Under this model, pension fund trustees entrust the assets of the fund to a fund management company (possibly more than one), leaving both strategic asset allocation and security selection to them. Manager performance is measured with reference to the relevant peer group and managers' objectives are similarly defined: for instance, to outperform the average or median, or to rank among the top quartile of performers over a specified or unspecified period.
36. This was the dominant model in private sector segregated defined benefit schemes until the mid-1990s. It is declining in this sector, but remains important in pooled pensions and continues to be widely used for local authority schemes.

#### ***Approach 2: the customised benchmark model***

37. The alternative model separates out decisions about strategic asset allocation from decisions about security selection. Instead of entrusting all their funds to a single manager with a peer group benchmark, trustees use a specialist mandate and customised benchmark, which may take one of two principal forms:
  - specific instructions to the manager to invest in one asset class only, usually with the relevant index as a benchmark; or
  - a mandate to invest in more than one asset class, but with a benchmark that combines the relevant indices or peer returns for the various asset classes in a fixed proportion, effectively setting parameters for the fund manager's asset allocation.

38. The stock selection decision therefore remains with the manager under this model, but the strategic asset allocation decision rests with the trustees.
39. These two approaches to investment decision-making have different implications.

### ***Implications of the balanced mandate/peer group benchmark***

40. At first glance, a peer group benchmark has some intuitive appeal. Having hired a fund management company to invest their assets for them, trustees wish to incentivise the manager to perform better than others.
41. Unfortunately, the appeal is deceptive. The aim of defined benefit pension funds is to pay the pensions that members have been promised. Their primary objective is therefore to achieve a certain liability-related level of return. They may well have secondary objectives, too: to exceed this return, where possible, in order to reduce the costs to the employer of providing the pension or enhance the prospect of benefit improvement; and to minimise the volatility of returns, so that the sponsor is not forced to vary contribution rates.
42. Yet under the balanced mandate arrangement, pension funds are setting an entirely different objective: to outperform other UK pension funds. This bears only an indirect relationship to any of the objectives above. Clearly there are many scenarios in which the fund manager will achieve the stated objective of performing better than the peer group without contributing to delivering what the pension fund really needs: a liability-related return – for example, where UK pension funds as a group herd around an asset allocation that generates poor returns.
43. The peer group benchmark has a further distorting effect, tending to produce investment decisions – in particular asset allocation – based on what other funds are doing. This is not in the best interests of pension funds and their members. A pension fund should set its asset allocation because it believes, on the evidence available, that a particular allocation will best enable it to meet its liabilities at its projected rate of contribution, not because other pension funds have a similar allocation. The latter approach fosters inertia: once most pension funds are not invested in a given asset class, it becomes very difficult for one manager to break ranks and invest differently, however good the prospects for that asset class might be.
44. The review believes that the peer group benchmark model is a mistaken way of managing pension fund investment. This applies most obviously to defined benefit schemes, but also to defined contribution schemes. Members of a defined contribution scheme can take little comfort from discovering that their fund has beaten the returns of the peer group average or median, if the result is below the level required to produce the pensions that they expect.

### ***Fund managers: security selection in the customised benchmark model***

45. Once an asset allocation decision has been made, on the customised benchmark model, responsibility for investing the assets passes to one or more fund managers.
46. The main incentives acting on managers are those generated by their benchmark: in the case of the customised benchmark model, usually the index. In this context, the function of an index is to assess how the manager has performed relative to the relevant asset class as a whole, with the index serving as a proxy for that asset class.
47. Pension funds are increasingly concerned with managing the risk around this benchmark. It is reasonable that, having made an asset allocation, they wish to set limits to divergence

from the index in order to prevent the fund manager taking security selection bets of such extremity that their asset allocation policy is negated. But such limits must be viewed with caution. There is inevitable arbitrariness at the margins about which stocks come to be included in an index.

48. For example, when Vodafone acquired Mannesmann last year, managers with a UK equity mandate sought to buy additional Vodafone shares to reflect its increased weight in the UK market. Had Mannesmann acquired Vodafone (which was not out of the question, given their similar size), this would have resulted in essentially the same enterprise – but listed on the German stock market. Yet those same managers would have sold their shares of ‘Mannesmann-Vodafone’, as it was a German security and therefore not in the UK stock market index.
49. This sort of anomaly cannot be avoided entirely. It does, however, lead to two clear conclusions. First, the precise choice of index is an important investment decision, the implications of which are perhaps not always fully appreciated by pension scheme trustees.
50. Second, setting tight limits on divergence from the index leads to distortions. Monitoring tracking error – in effect the likelihood of achieving a return different from that of the index – incentivises managers to hug their benchmark, making only small bets away from it. They may hold stocks which they believe will underperform the index but which they need to hold in order to reduce the risk of significant deviation from performance of the index. In this situation, pension funds are paying fees for active management when its true style is becoming increasingly passive: adding less and less value, and offering less and less innovative stock selection strategies.

### ***Timescales***

51. A further problem is that of timescales. The accusation that ‘the City is short-termist’ has been around for a long time, under various guises. In the case of institutional investors, the culprit traditionally cited (and respondents to the review were no exception in this) is the quarterly trustees’ meeting, which leads to quarterly appraisal of managers. This in turn makes fund management firms’ internal appraisal and monitoring systems focus strongly on short-term performance.
52. Trustees and their advisers, by contrast, insist that they are not concerned by short-term performance and would not change a manager as a result of poor performance over the short-term.
53. The review believes that what is lacking in these circumstances is clarity. If clients are – as at present – extremely vague about the time horizons over which managers’ performance will be judged, managers will, perfectly rationally, assume that they *could* be dismissed after *any* quarter’s performance. This has the potential to encourage managers to adopt an investment approach which does not reflect either their clients’ wishes or their long-term interests.

### ***Intervention in failing companies***

54. In managing pension funds’ assets, fund managers have also pursued only a limited range of strategies to deliver value to clients. In particular, the review found evidence of general reluctance to tackle corporate underperformance in investee companies, particularly pre-emptive action to prevent troubled companies developing serious problems.
55. The review was given a number of reasons for this, none of which it believes to be compelling:

- a culture that seeks to avoid conflict;
  - unwillingness of managers to act on judgements about the strategy and top management of the companies in which they retain holdings, despite being highly paid to make such judgements;
  - alleged regulatory obstacles, which the review found difficult to verify;
  - the lack of incentive for managers to intervene in a company, if they feel the key issue for their client is the next quarter's performance figures; and
  - potential conflicts of interest.
56. If fund managers are truly to fulfil their duty of seeking to maximise value for their shareholders, then there will be times – certainly more than at present – when intervention is the right action to take. Of course there are many occasions when simply selling an entire holding is the appropriate response. But this is often difficult where holdings are large, where the share price is already depressed, or where a zero holding cannot be adopted for other reasons (such as constraints on departures from an index benchmark).
57. The case for action does not rest on a public interest argument about shareholder responsibility but on the basic duty of the manager to do their best for the client. Nor need (or should) it represent 'micro-management' by fund managers.

### ***Brokers' commissions***

58. The sum which pension funds pay in commissions to investment houses, stockbrokers and so on, for providing dealing and research may well be similar in size to the fees which they pay for active fund management. Yet the treatment of these costs is different to that of the fund management fee in two important respects.
59. First, although they are disclosed, this is done in a way which is far from transparent. The aggregate cost to a fund of commissions over a period is not something which must necessarily be calculated. Rather, disclosure to the client is on the note confirming the transaction, not a document of particular interest to trustees. Second, the firms which provide the services for which commission is charged are selected by the fund manager, acting as the agent for the institutional client. The client has no direct involvement in the decision, and the process by which these fees are negotiated is not transparent to the client. Some (not all) fund managers have put in place a formal assessment process for determining the quality of service they receive from the sell-side firms to whom they give business. But their incentive to target price paid as part of this process is the impact that commission levels have on fund performance. While helpful, this is not the same as more direct pressures on business costs.
60. There is an *a priori* case that this system creates an artificial bias for fund managers to have services provided by the sell-side, since the costs for these will not be scrutinised directly by the client.
61. Clients' interests would be better served if they required fund managers to absorb the cost of any commissions paid, treating these commissions as a cost of the business of fund management, as they surely are. Fund managers would of course seek to offset this additional cost through higher fees; this would be a matter for them to agree with their clients. Under this system, the incentives would be different. Institutional clients would see more clearly what they were actually paying to have their funds invested. Incentives for them to manage fees would apply equally to all fees, as opposed to acting on some more than on others, as at present. Fund managers would choose which services to buy and which to provide themselves. They would face a commercial tension between wishing to cut costs

on the one hand, but wanting to achieve superior investment returns on the other. This is healthy. The pressure would be to purchase only those services which contributed to such returns, and to do so in the way which is most efficient.

### ***A regulatory issue – the Minimum Funding Requirement***

62. The Minimum Funding Requirement (MFR) was a particular focus for the review because of the high level of interest in the issue shown by respondents to the review's consultation. The review submitted a proposal to the Treasury/Department of Social Security consultation process on the MFR, which argued as follows.
63. The MFR distorts investment decision-making by its use of a set of reference assets to calculate discount rates for liabilities. Pension funds are not required to invest in these assets, but to do so is the best way of minimising volatility against the funding standard. Nor does the MFR provide effective protection for members of defined benefit pension schemes. Any fixed standard such as the MFR simply records the state of the fund at one point in time, but financial markets and economic conditions change constantly. The fact that the fund has hit a funding target can create a false sense of security. Moreover, by distorting pension fund investment and so imposing direct costs on defined benefit pension funds, the MFR creates very real additional incentives for employers to close defined benefit schemes.
64. The MFR and all funding and solvency standards focus attention on the wrong question: whether, given certain investment assumptions and methods of calculating liabilities, the value of a defined benefit pension fund's assets exceeds its liabilities at a given date. This is not the same question as whether or not a pension fund will in practice be able to pay its pensions. That will depend on future investment returns and the investment strategy of the fund, which in turn depends on its maturity, the strength and risk appetite of the sponsoring employer and the views and actions of the trustees.
65. The review therefore proposed that there should instead be a regime based on transparency and disclosure, exposing the scheme's funding and investment plans to scrutiny. Each defined benefit pension fund would be required each year to set out the state of the fund and future plans for paying pensions in a 'transparency statement'. The process of having to prepare a statement of these matters would encourage trustees to think carefully about whether their investment strategy is sound. Making it publicly available would expose it to public scrutiny.
66. There is then the question of what mechanisms should be put in place to ensure that transparency operates effectively. The review suggested an independent report commissioned by members. A number of respondents were concerned at the practical implications of the idea and suggested other alternatives.
67. The essential principles of the review's proposals for protecting members of defined benefit schemes from underfunded pension funds are set out above: that there should be a long-term, scheme-specific approach based on transparency and disclosure with no centrally dictated set of reference assets distorting investment decisions. For that reason, it does not agree with proposals for a standardised test, even if it were only applied to some portion of the benefits. This would still create artificial incentives to match the assets used to generate the discount rate for the liabilities. But the review believes that other respondents' detailed suggestions, which go with the grain of the review's proposals, have merit and should be considered by the Government.

## **Defined contribution schemes**

68. Much of the review's analysis focuses on occupational defined benefit pension schemes, since these still account for the great majority of pension assets. Many of the issues raised above apply equally to the growing number of defined contribution schemes. In particular:
- the level of trustees' investment expertise;
  - the resources they are able to bring to bear on their responsibilities; and
  - the incentives they create for fund managers through the process of performance measurement.
69. The nature of defined contribution schemes also raises a number of specific issues. They can offer individuals choice as to how their funds are invested. But it is unclear how trustees should decide which options to offer to members, and how many. The more they offer, the less likely it is that members could successfully claim that their investment choice had been restricted. But equally, the more options offered, the more complicated the decision becomes for members, who may then find it easier to argue that trustees have not acted in their best interests. There is no guidance on these issues and little in the way of legal precedent.
70. In such a situation, there is a danger that trustees will fall back on the familiar strategy of following standard industry practice in terms of the number and type of funds offered, especially in their approach to default options, which are very popular with members. This means that pension fund assets will again be invested on the basis of a historic industry consensus about what represents 'appropriate' assets for investment, rather than on a well-informed assessment of the full range of investment opportunities.
71. There also appears to be misunderstanding about the attitude which defined contribution schemes should take to risky and illiquid assets. There appears to be a widespread belief that defined contribution schemes cannot invest in such assets because:
- members bear the investment risk;
  - the scheme needs to be able to provide a valuation of the account for each member, either for information purposes or to enable members to move their pension account to a different scheme; and
  - there is no pooling of members' risk, as there is with defined benefit schemes.
72. These beliefs are somewhat overstated. It is true that defined contribution schemes need to invest in assets with a clear market price in order to enable equitable treatment of those purchasing, selling or retaining units in the fund. In that sense liquidity is a consideration – it must be possible to price the assets fairly. However, this need not bar defined contribution schemes absolutely from investing in private equity. One vehicle for doing so already exists – the quoted investment trust – and the growth of defined contribution assets should create an incentive for further innovation in this area.
73. It is also true that defined contribution schemes' inability to pool risk means that a defined contribution scheme should quite properly be more conservatively invested than an equivalent defined benefit scheme. But it does not follow from this that risky asset classes are not appropriate for anyone except the young and risk-hungry members of these schemes. A modest investment in volatile assets even ten years from expected retirement as part of a diversified portfolio does not significantly increase the risk to retirement income. To argue that a particular asset class is by its very nature 'too risky' ever to be invested in by defined contribution schemes as a group cannot be right.

74. The review has noted that defined contribution schemes also raise a range of further issues because of the important role played by commercial pensions providers (usually life insurers) and by individuals. Issues such as the nature of advice and information available to scheme members and the commercial incentives involved are significant in driving investment behaviour. Proposals for these issues are dealt with in the analysis of the life insurance industry.

### ***Pension funds: conclusions and key proposals***

75. The review believes that the distortions it has described in its analysis are a cause for policy concern, and that change needs to take place in order to rectify them. It therefore makes a number of proposals, the most important of which are described below.

#### **• trustee expertise**

76. First, the level of expertise of pension fund trustees is clearly key to the effectiveness of investment decision-making. The trust structure places them at the heart of pension fund decision-making, yet there is no legal requirement for them to develop the skills they need to carry out their investment duties. They are only expected to show the skill and prudence of an 'ordinary man of business'.
77. The review therefore proposes that there should be a legal requirement that, where trustees are taking a decision, they should be able to take it with the skill and prudence of someone *familiar with the issues concerned*, as in the US. If trustees do not feel that they possess such a level of skill and care, then they should either take steps to acquire it, or delegate the decision to a person or organisation who they believe does.

#### **• the surplus**

78. The relationship between a pension fund and its sponsor company is a crucial potential source of support for trustees in their investment decision-making duties. The review believes that the current lack of clarity about ownership of any surplus assets is damaging, leaving companies with a diminished incentive to take an active interest in the investment performance of their fund. It therefore recommends two changes:

- the Law Commission should be asked to review whether greater clarity over ownership of the surplus can be achieved through legal change; and
- the tax rate on the withdrawal of surplus should be reduced. The present rate of 40% is anachronistically high.

#### **• activism**

79. Third, the review is particularly concerned by the value lost to institutional investors through the reluctance of fund managers to actively engage with companies in which they have holdings, even where they have strong reservations about strategy, personnel or other potential causes of corporate underperformance. It therefore recommends that the US Department of Labor Interpretative Bulletin on Employment Retirement Income Security Act (ERISA) 1974 which deals with this issue be included in fund management mandates, and incorporated in law. The guidance clearly articulates the duties of managers to intervene in companies – by voting or otherwise – where there is a reasonable expectation that doing so might raise the value of the investment.



## **Principles**

80. In addition, the review sets out in Chapter 11 a short series of principles which it believes codify best practice for pension fund decision-making. Some of the main points are:
- Decisions should be taken only by persons or organisations with the right skills, information and resources needed to take them effectively.
  - Trustees should set out an overall investment objective for the fund, in terms which relate directly to the circumstances of the fund and not to some other objective such as the performance of other pension funds.
  - The attention devoted to asset allocation decisions should fully reflect the contribution they can make to achieving the fund's investment objective.
  - Decision-makers should consider a full range of investment opportunities across all major asset classes, including private equity.
  - The fund should be prepared to pay sufficient fees for actuarial and investment advice to attract a broad range of kinds of potential providers.
  - Trustees should give fund managers an explicit written mandate setting out the agreement between them on issues such as the investment objective, and a clear timescale for measurement and evaluation.
  - In consultation with their investment manager, funds should explicitly consider whether the index benchmarks that they have selected are appropriate. Where they believe active management to have the potential to achieve higher returns, they should set both targets and risk controls that reflect this, allowing sufficient freedom for genuinely active management to occur.
  - Trustees should arrange to measure the performance of the fund and the effectiveness of their own decision-making, and formally to assess the performance and decision-making delegated to advisers and managers.
81. The following proposals are specifically for defined contribution schemes:
- In selecting funds to offer as options to scheme members, trustees should consider the investment objectives, expected returns, risks and other relevant characteristics of each such fund.
  - Where a fund is offering a default option to members through a customised combination of funds, trustees should ensure that an objective is set for the option, including expected risks and returns.
82. These principles might appear basic, but the review believes that they call for considerable change in pension fund practice.

## **Implementation**

83. One way to bring about such change would be for the Government to seek to compel pension funds to behave in the desired way through regulation. However, the review believes that regulation is a blunt instrument, which cannot easily accommodate the diverse nature of pension funds.
84. By contrast, the successful implementation of the Combined Code of the Committee on Corporate Governance, and its forerunner the Cadbury Code, demonstrates that a good practice model, backed up with disclosure requirements, can be a powerful force for behavioural change. The review believes that an analogous approach for pension funds and

other institutional investors should be tried.

85. The review therefore proposes that pension funds should set out annually what they are doing to comply with each of the principles. Where they choose not to meet a particular principle, they should explain publicly and to their members why not.
86. In this way, the review believes that annual reporting by all pension funds to their beneficiaries and other interested parties should evolve into a forum where decision-makers explain and justify their approach (including the resultant investment outcomes), and stakeholders oversee the decisions made on their behalf.
87. It further recommends that in two years' time, the Government should review the extent to which the principles have been effective in bringing about behavioural change.
88. The review recommends that the Government should consult on the detail of the principles, and then promulgate them. Should the industry not be willing to adopt them voluntarily – the preferred approach – the review believes that the scale of the distortions it has identified would justify enforcement of disclosure against the principles through legislation.

## A better-functioning system

It may be helpful to sketch out how a better-functioning system of decision-making for pension funds could work. The review does not have a particular structure in mind: a variety of institutional arrangements could be consistent with sensible approaches to investment decision-making. There are, however, certain common features which such arrangements would be likely to share.

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.

## ***Life insurance***

89. The other major focus of the review is life insurance – the second major group of institutional investors.
90. Most of the business which life insurers conduct is now not straightforward insurance, but savings and investment. On behalf of their policyholders, they account for a large part of the UK's equity markets. It is therefore a legitimate matter of policy concern to ask of these assets, as the review does of pension funds, how far the investment-making approaches of life offices are:
  - rational;
  - well-informed;
  - subject to the correct incentives; and
  - as far as possible, undistorted.
91. Unlike occupational pension funds, life offices compete directly for policyholders' investments. In principle, the competition to attract investors by achieving superior investment performance should drive towards rational investment decision-making, and therefore efficient capital allocation. In practice, however, several factors work against this.
92. Retail consumers, the end customers of the life companies, tend to have a poor understanding of investment and savings issues, which in itself makes effective competition on the basis of investment performance difficult.
93. Partly as a result of this, Independent Financial Advisers (IFAs) play a very important part in the sales process, advising customers on which product to buy. However, IFAs are typically paid commissions of differing levels by life companies, and offering higher commission than competitors is viewed as an important factor in generating increased sales, particularly for lesser-known life offices. Differing commission levels on different types of products also

appear to affect sales. The review has been told that certain products which otherwise appear very similar to others from a financial planning perspective can generate much higher sales as a consequence.

94. This casts doubt over whether competition for policyholders by life offices is in fact on the basis of investment performance. This is a particular concern in the case of with-profits policies.
95. Insurance companies compete for with-profits business not on the basis of the underlying fund's investment performance but rather on the level of reversionary and terminal bonuses paid to customers. It might appear that the two should correspond in a relatively straightforward way, as those life insurance offices with the highest risk-adjusted returns would be able to pay the highest bonuses.
96. This is not the case in practice. First, the cost of surrendering a life policy part-way through its life means that competition is already heavily focused on the point of purchase. In deciding to recommend one policy over another at that crucial point, IFAs tend to look at the historic returns achieved by a supplier and compare them to competitors. Yet historic investment performance is generally a poor guide to future performance.
97. The nature of with-profits policies makes this even more strongly the case. Life insurance companies do not generally tell customers the return on the life fund. The relationship between investment performance and the level of bonuses paid is indirect, since there are no clear rules setting out how annual and terminal bonuses should be calculated. A company might, for example, increase its level of reversionary bonuses over a period of years by utilising its reserves, thus generating improved short-term returns. Since the underlying investment performance of the fund is not reported, the long-term consequences of such a strategy would not be clear to potential customers. Alternatively, a fund might pay high terminal bonuses in a year when relatively few policies are maturing, which it would not be able to maintain in later years. This would again temporarily generate unsustainably high returns.
98. Another proxy for potential investment performance which acts as a basis for competition is a company's Free Asset Ratio – the ratio of its surplus long-term assets to its total liabilities. However, this, too, is affected by factors unrelated to the company's financial strength: for example, it increases if some of a company's liabilities are reinsured.
99. Although competition in the life insurance industry is fierce, it takes place on the basis of proxies that relate only poorly at best to investment performance. This is clearly very significant, both for capital allocation in the economy and for millions of savers.
100. To tackle these issues effectively, although it would undoubtedly improve incentives for effective investment decision-making, would also raise issues that go far beyond the already broad remit of this review.
101. The review therefore recommends that the Government should initiate a separate independent review of capital and information flows around personal investment products.
102. The review also believes that the principles of effective investment set out in this report should be applied to the markets that this further review would consider. The review therefore proposes that the further review should consider how to apply the principles of effective investment (proposed in Chapter 11) to these product markets.

## **Private equity**

103. Private equity (that is, the provision of risk capital to unquoted companies), forms an important focus for the review, both in its own right, because of its importance to the UK economy, and as an example of the issues that prompted the review.
104. Private equity has certain features which make it a difficult asset class for institutions to invest in:
- its illiquidity, and the difficulty of pricing it quickly and easily on a market;
  - the complexity and importance of the sources of advantage in the industry, and consequently the importance of specialist investment advice about the asset class.
105. The UK industry also raises some specific issues:
- a history of mixed returns, with a wide dispersion between the performance of different partnerships; and
  - some regulatory barriers, although most do not appear to be absolute.
106. However, the willingness of overseas institutions – particularly from the US – to invest in UK private equity provides a striking contrast to the relative reluctance of UK institutions to invest in those same opportunities. In 1999, overseas investors provided over 70 per cent of the UK private equity industry’s funding. Investment by overseas pension funds in UK private equity has more than tripled since 1996; over the same period, the level of annual investment by UK pension funds in UK private equity has fallen.
107. The review believes that its broader proposals – especially the principles set out in Chapter 11 – will have a significant and positive impact on decision-making about private equity. In particular:
- they propose that trustees should consider a full range of investment opportunities, including private equity;
  - an overall, liability-related investment objective should be much more conducive to private equity investment than a peer group benchmark or an asset allocation driven by a statistical modelling process;
  - a focus on ensuring that decisions are taken by those best placed to make them is likely to be helpful to specialist asset classes;
  - the decision to invest in private equity is made at the level of strategic asset allocation, so greater investment of time and resources into the asset allocation decision is likely to be beneficial;
  - efforts to involve a wider range of advisers with specialist skills would encourage pension fund trustees to obtain quality advice on the role of private equity and its application, thereby boosting the demand for information services in the private equity market;
  - replacing the MFR with an approach based on transparency and disclosure would remove a bias towards the reference assets used to calculate MFR funding; at present, this disadvantages investment in private equity; and
  - more knowledgeable trustees working in a more business-like fashion with more in-house staff would be in a better position to understand the specific issues raised by private equity.

108. At the same time, private equity raises a range of specific issues not covered by the analysis so far. They are considered in Chapter 12, where the review makes a number of specific recommendations – including a change to the taxation of limited partnerships – which remove barriers to investment in this asset class.

## ***Conclusion***

109. Institutional investment in the equity markets has been a major success story for the UK, enabling millions of pension scheme members, individual policyholders and investors to benefit from stock market returns.
110. The review has identified a number of distortions in the investment decisions which underlie these vast flows of capital, however. Key decision-makers do not always have the skills, expertise and information to carry out their responsibilities effectively. Lack of clarity about decision-making structures and incentives causes the misalignment of the objectives of the ultimate investors – the millions of consumers and pension fund members – and the agents investing on their behalf.
111. The review believes that the proposals it makes in response to these issues present an opportunity to achieve genuine behavioural change, and to establish a more rational and considered framework for decision-making in institutional investment. Clear, transparent objectives and responsibility structures; specialist expertise for decision-makers; and greater intellectual competition in the market for advice should lead to less herd-like behaviour, and a rich, complex tapestry of investment approaches.

# Recommendations

## ***Pension funds: the context for investment decision-making***

- The review recommends that trustees should assess the effectiveness of their own contribution to meeting the objectives of the fund as they do that of their advisers and fund managers, considering issues such as:
  - whether or not the decision-making structures they have in place address the task of effectively running their fund;
  - whether their division of time between their various responsibilities is right;
  - whether they have the right mix of skills and experience collectively; and
  - whether the fund's control environment is fit for the purpose.
- The review recommends that it is good practice to pay trustees, unless there is a specific reason why this may be unnecessary (for instance where they are senior executives of the sponsor company).
- The review proposes that there should be a legal requirement that where trustees are taking a decision, they should be able to take it with the skill and care of someone *familiar with the issues concerned*. If they do not feel that they possess such a level of skill and care, then they should either take steps to acquire it, or delegate the decision to a person or organisation who they believe does possess this level of skill and care.
- The review recommends that the Statement of Investment Principles (SIP) should be strengthened so that members gain access to better quality information as a matter of course, and that it should be sent out to members annually.
- The review recommends that it is good practice for pension funds to have an investment subcommittee.
- The review recommends that trust deeds should not prohibit the use of particular instruments such as derivatives or prohibit investment in certain asset classes. Nor, other than with good reason, should SIPs or fund managers' mandates. Where they do contain unjustified prohibitions, they should be amended.
- The review recommends that funds and their sponsors should increase their investment in training for trustees.
- The review recommends that sponsor companies should ensure that trustees have sufficient in-house staff to support them in their investment responsibilities.

## ***Investment decision-making by trustees***

- The review recommends that trustees should:
  - set out explicitly an overall investment objective for the fund which represents their best judgement of what is necessary to meet the fund's liabilities;
  - set objectives for their fund managers that are coherent with the fund's aggregate investment objective; and

- set out explicitly what decision is being taken by whom. Decisions on the investment of the fund should be taken only by those with the skills, information and resources necessary to take them effectively.

### ***Actuaries and investment consultants***

- The review recommends that contracts for actuarial services and investment advice should be opened to competition separately. Pension funds should be prepared to pay sufficient fees for each service to attract a broad range of kinds of potential provider.
- Trustees should arrange for formal assessment of their advisers' performance and of any decision-making delegated to them.
- Trustees should not take investment advice on an asset class from an investment consultant who lacks expertise in that asset class.
- Fees devoted to asset allocation should properly reflect the contribution it can make to the fund's investment performance.

### ***Fund managers***

- The review recommends that funds should:
  - explicitly consider, in consultation with their investment manager, whether the index benchmarks that they have selected are appropriate; in particular, whether the construction of the index creates incentives to follow sub-optimal investment strategies;
  - set limits on divergence from the index which reflect the approximations involved;
  - consider explicitly for each asset class invested whether active or passive management would be more appropriate; and
  - where they believe active management to have the potential to achieve higher returns, set both targets and risk controls which reflect this, allowing sufficient freedom for genuinely active management to occur.
- The review recommends that pension funds should provide fund managers with clarity about the period over which their performance will be judged – and hold to that under the terms of the contract, unless clearly abnormal circumstances arise.
- The review recommends that all pension fund trustees should incorporate the principle of the US Department of Labor Interpretative Bulletin on activism into fund management mandates. It also recommends that the principle should in due course be more clearly incorporated into UK law.
- The review recommends that it is good practice for institutional investment management mandates to incorporate a management fee inclusive of any external research, information or transaction services acquired or used by the fund manager, rather than these costs being passed on to the client.

### ***Defined contribution schemes: specific issues***

- The review recommends that the National Association of Pension Funds investigate ways of collecting more comprehensive data on the investment decisions of defined contribution schemes.



- The review recommends that investment decisions taken on behalf of defined contribution scheme members should accord with the principles set out in Chapter 11. In particular:
  - a) where a fund is offering a default option, trustees should ensure that an objective is set for the option, including expected risks and returns; and
  - b) when selecting investment options, trustees should:
    - take into account the members' preferences; and
    - ensure that they offer a sufficient range of funds to satisfy the risk and return combinations reasonable for most members.
- The review recommends that defined contribution schemes should, as a matter of best practice, consider a full range of investment opportunities, including less liquid and more volatile assets. In particular, investment trusts should be considered as a means of investing in private equity.
- The review recommends that the Government should keep under close review the levels of employer and employee contributions to defined contribution pensions, and the implications for retirement incomes.

### ***Pension fund surpluses***

- The review recommends that the tax rate on the withdrawal of surplus should be reduced.
- The review recommends that the Law Commission should be asked to review whether the objective of maximum clarity over ownership of the surplus can be achieved through legal change.

### ***Minimum Funding Requirement***

- The review recommends that the MFR should be replaced by a regime based on transparency and disclosure, under which pension funds would report publicly on the current financial state of the fund and on future investment plans.
- The review proposes that each defined benefit pension fund should be required each year to set out in clear and straightforward language such matters as:
  - the current value of its assets and in what asset classes they were invested;
  - the assumptions used to determine its liabilities;
  - planned future contributions;
  - its planned asset allocation for the following year or years;
  - the assumed returns and assumed volatilities of those returns for each asset class sufficient to meet the liabilities;
  - a justification by the trustees of the reasonableness of both their asset allocation and the investment returns assumed in the light of the circumstances of the fund and of the sponsor; and

- an explanation of the implications of the volatility of the investment values for possible underfunding, and a justification by trustees of why this level of volatility is judged to be acceptable.
- The review recommends that the level of compensation provided by the Pensions Compensation Board for non-pensioner members be increased to cover not simply the 90 per cent of MFR liabilities as at present, but something closer to the cost of securing members' accrued rights (or the amount of the loss, whichever is the lesser).
- The review recommends that there should be a statutory requirement for funds to have independent custody.
- The review recommends that the Government continues to take a close interest in the current European discussions on pension provision. The Government should make the case in Europe that such standardised requirements are flawed and counterproductive, and are not in the best interests of pensioners.

### ***Life insurance***

- The review recommends that the practical effects of the 10 per cent ceiling on investment in limited partnerships should be kept under review by the Financial Services Authority (FSA).
- The review recommends that the FSA should publicise its willingness to consider concessions from the readily realisable rule.
- The review recommends that the Government should initiate a separate independent review of capital and information flows around personal investment products.
- The review proposes that the further review should consider how to apply to these products the investment principles proposed in Chapter 11.

### ***Pooled investment vehicles***

- The review recommends that the proposed review of personal investment products should include within its remit the market for unit trusts/open-ended investment companies and investment trusts.
- The review recommends that the further review should consider how to apply to these products the investment principles proposed in Chapter 11.

### ***Principles***

- The review recommends that pension funds should set out in their Statement of Investment Principles (which should be annually distributed to members) what they are doing to implement each of the principles set out in Chapter 11. Where they choose not to meet a given principle, they should explain publicly, and to their members, why not.
- The review believes that the scale of the distortions it has identified would justify requiring funds to report their compliance with the principles through legislation, if the industry does not adopt them voluntarily.
- The review recommends that in two years' time, the Government should undertake a public assessment of the effectiveness of the principles in bringing about behavioural change.

## ***Private equity***

- The review recommends that the Government continues to strengthen its programme of public-private venture fund partnerships, with the aim of filling gaps in the regional and technology venture capital markets. The review also recommends that as the venture capital market evolves, the Government keeps under close review the impact of its tax and regulatory measures in this area.
- The review recommends that the British Venture Capital Association (BVCA) increase its efforts to educate potential investors, the media, Government and Parliament about the role and economic contribution of private equity in general and about the differing characteristics of the various subsectors within it. This should support the long-term health of the UK private equity market, through better understanding among UK institutional investors, and should complement the marketing and raising of capital from overseas sources.
- The review recommends that the BVCA should continue an active dialogue with the UK institutional investor community to educate investors about the validity of valuation techniques and to respond to any emerging concerns about the use, non-use or abuse of the BVCA's own guidelines.
- The review recommends that the BVCA establish and disseminate guidelines on the comprehensive – and independently audited – valuation of all investments made by private equity funds, where firms later use those valuations for marketing and/or fund-raising purposes. In preparing the guidelines, the BVCA should actively consult those UK institutions currently investing in private equity.
- The review recommends that the BVCA enhance the quality and credibility of the industry benchmark data by further increasing coverage among its UK private equity member firms from the current level of 95 per cent, and introducing some degree of independent auditing of reported returns. As the market for private equity increasingly develops along European lines, the review recommends that BVCA work closely with the European Venture Capital Association to produce comparably accurate, detailed and credible performance data for European private equity funds as a whole.
- The review recommends that the BVCA, in consultation with established UK institutional investors in private equity, should encourage greater transparency among its members about contract terms. As part of this, it should produce comprehensive guidance for institutional investors about the full range of potential parameters in private equity contracts and their impact on net returns to investors. The review strongly supports healthy competition between private equity firms on all the parameters in remuneration contracts, and believes that the recommended approach should encourage this by strengthening the hand of investors.
- The review recommends, as in its interim report, that the Government should modify the regulation implementing the Financial Services and Markets Act, so that where an investment is made in a limited partnership solely for the purpose of investing that money onward in private equity investments, it is exempt from the prohibition in the Act on unauthorised persons engaging in investment activity.
- The review recommends that the Government should legislate to change the taxation of capital gains on insurance companies' limited partnership investments by moving from taxation based on capital gains at partnership level (involving complex calculations and valuations) to taxation of the gains as distributed from the fund.

- The review recommends that the Government should consider change to the law affecting limited partnerships to increase significantly the maximum number of partners per partnership (from the current limit of 20), and to remove the legal uncertainty on the ability of institutional investors to participate in an investment advisory/oversight role for the partnership, without jeopardising their status as limited partners. This should encourage the use of advisory boards as an effective means of facilitating institutional oversight of funds and improving accountability and communication.
- The review recommends that the FSA establish a centre of expertise on private equity investment business.

### ***Local Authority pensions***

- The review recommends that local authority pension schemes should disclose their compliance or otherwise with the principles set out in Chapter 11.
- The review recommends that the Government should consider to what extent the proposals it has made to replace the MFR should be applicable to local authorities, including the proposal for mandatory independent custody.
- The review recommends that the prudential limits on particular types of investment, particularly those relating to investment in limited partnerships, should be kept under review by DETR.

# CHAPTER 1: Institutional Investment

## Introduction

1.1 This chapter sets out the main types of institutional investor and briefly describes some of their key characteristics.

### *Types of institutional investor*

1.2 The main types of institutional investor are:

- occupational pension funds;
- insurance companies;
- pooled investment vehicles, such as unit trusts, open-ended investment companies (oeics) and investment trusts; and
- other financial institutions such as charities, endowments and educational institutions.

### *Historical trends in institutional investment*

1.3 As a long-term trend, institutions have acquired an increasing proportion of capital in the UK economy (see Table 1.1). The UK equity market has become steadily more 'institutionalised' since the early 1960s, with individual share ownership dropping from over 50 per cent of the market to under 20 per cent.

1.4 This has been a complex process driven by a number of factors. Institutional saving offers some risk pooling as individual investment is collectively invested with that of others under the direction of specialist managers. But tax considerations have also been very important. For example:

- pension fund investments are free of capital gains tax, and contributions to pensions are made out of pre-tax income;
- life insurance has in the past benefited from tax privileges; and
- unit trust portfolios are exempt from capital gains tax, with any liability to taxation falling on the individual investor as a consequence of disposal. Unit trusts have been a very

**Table 1.1: The institutionalisation of the UK equity market**

Institution	End Year							
	1963 (%)	1975 (%)	1981 (%)	1989 (%)	1994 (%)	1997 (%)	1998 (%)	1999 (%)
Pension funds	6.4	16.8	26.7	30.6	27.8	22.1	21.7	19.6
Insurance companies	10.0	15.9	20.5	18.6	21.9	23.5	21.6	21.6
Unit trusts, investment trusts & other financial institutions	12.6	14.6	10.4	8.6	10.1	10.6	9.0	9.7
Banks	1.3	0.7	0.3	0.7	0.4	0.1	0.6	1.0
<b>Total UK institutions</b>	<b>30.3</b>	<b>48.0</b>	<b>57.9</b>	<b>58.5</b>	<b>60.2</b>	<b>56.3</b>	<b>52.9</b>	<b>51.9</b>
Individuals	54.0	37.5	28.2	20.6	20.3	16.5	16.7	15.3
Other personal sector	2.1	2.3	2.2	2.3	1.3	1.9	1.4	1.3
Public sector	1.5	3.6	3.0	2.0	0.8	0.1	0.1	0.1
Industrial & commercial companies	5.1	3.0	5.1	3.8	1.1	1.2	1.4	2.2
Overseas	7.0	5.6	3.6	12.8	16.3	24.0	27.6	29.3
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

Source: ONS, 'Share Ownership. A Report on the ownership of shares at 31/12/99', p8.

popular vehicle for tax-exempt Personal Equity Plans and then Individual Savings Accounts.

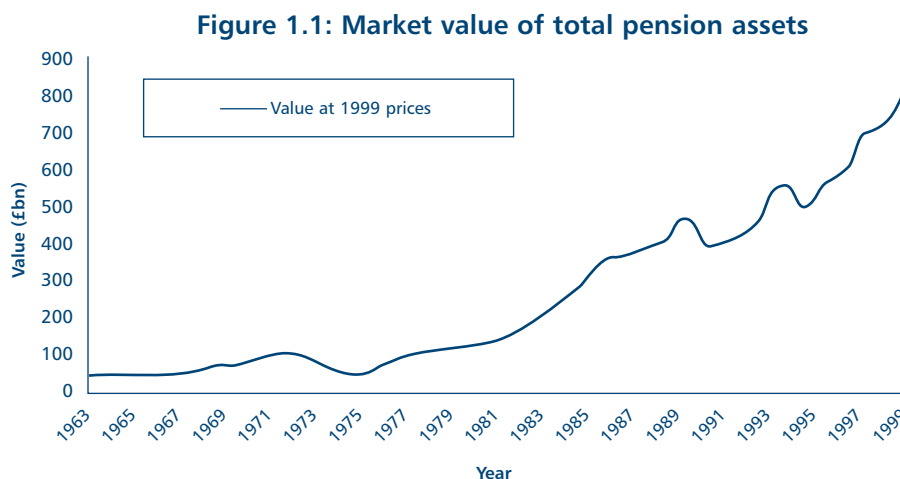
- 1.5 At the same time, increasing globalisation has driven a second trend: rising participation by overseas investors in UK capital markets. This is expected to continue, in parallel with some decrease in market ownership by UK institutions. Nevertheless, UK institutions continue to hold more than half of UK quoted equities and their central role is likely to continue for the foreseeable future.

### **Impact on the UK economy**

- 1.6 The strength of institutional investment in the UK has had a number of beneficial effects.
- 1.7 First, the strong presence of large and sophisticated institutions has been one of the factors ensuring that UK capital markets are among the deepest and most liquid in the world, enabling firms to raise capital efficiently through share and debt offerings.
- 1.8 Second, millions of savers and pension scheme members have benefited from UK institutions' willingness to make substantial equity investments over the past thirty years. Between 1963 and 1998, pension funds achieved average annual returns of 12.1 per cent compared with inflation of 7.2 per cent over the same period.
- 1.9 Third, institutional investment has undoubtedly been an important factor in the continuing competitive strength of the UK in financial services. The existence of substantial pools of capital has provided a large market to which specialised fund management services can be sold. This, in turn, provides an important market for research, market-making, derivatives, and other activities. It has been estimated that in 1998, the value added to the UK economy by fund management alone was approximately £3.8 billion.<sup>1</sup>

## **Occupational pension funds**

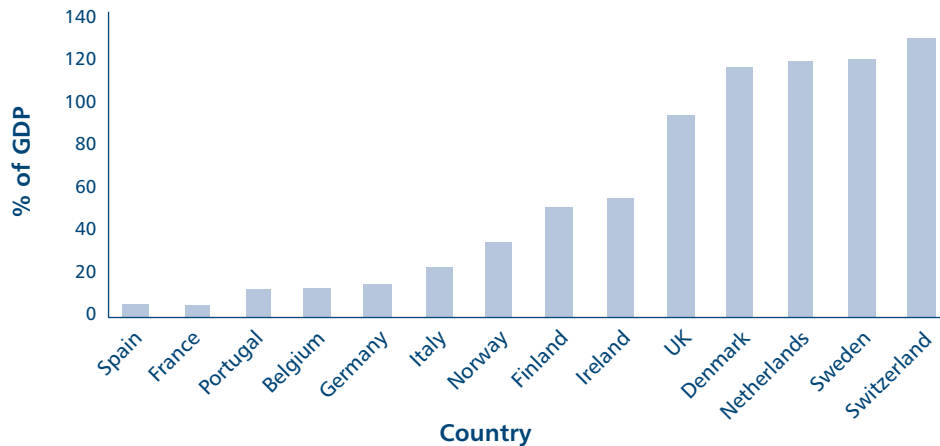
- 1.10 One of the attributes of the UK economy is the strength and prevalence of funded occupational pension schemes. This funded approach to retirement provision has arguably provided a competitive advantage for the UK economy. Funded pension schemes of this sort are common in other Anglo-Saxon countries, including the US, Australia and Canada. They are less common in continental Europe (although there are exceptions, notably the Netherlands). Figure 1.1 shows the growth in market value of pension assets in the UK. Figure 1.2 sets out pension assets as a percentage of Gross Domestic Product (GDP) for European countries.



Source: Phillips and Drew, 'Pension Fund Indicators, a long-term perspective on pension fund investment 2000', p.16.

<sup>1</sup> British Invisibles, *Fund Management* (City Business Series 2000: Statistical Update), p.14.

**Figure 1.2: Pension assets relative to GDP for European countries**



Source: Phillips & Drew, 'Pension Fund Indicators, a long term perspective on pension fund investment 2000', p.13.

## ***Types of pension scheme***

1.11 Pension schemes divide into two broad categories:

- defined benefit or salary-related schemes, where the pension is calculated as a percentage of the employee's salary on leaving the scheme, taking into account the number of years spent in the scheme. This 'pensions promise' is underwritten by the employer or sponsor of the scheme; and
- defined contribution or money purchase schemes. Here, the value of the pension is determined by the value of the annuity which the pool of assets accumulated in the fund at retirement can purchase. There is normally no guarantee by the employer.

1.12 Defined benefit schemes were the prevailing form of new pensions provision in both the private sectors and local authorities from the 1970s to the 1990s. This was for a number of reasons:

- they were already the dominant form of provision in old-established private companies and in the public sector. As a very significant employer in the early part of the period, the public sector had a considerable influence on labour market practice generally;
- many employees found them an attractive form of pensions provision, offering a degree of certainty in times of inflation and economic volatility;
- for employers, they encouraged staff retention, as moving between schemes was not advantageous;
- the rules meant that the sponsoring employer was free to decide the 'pensions promise' and precise package of benefits offered to members of the scheme; and
- defined benefit provision was then not as costly as it subsequently became for employers. The absence of a requirement to guarantee price indexation meant that employers were usually sharing inflation risk with members.

1.13 From the mid-1990s, however, defined benefit schemes have increasingly begun to close to new members or even to be wound up, their place taken by defined contribution schemes. This change is partly driven by a shifting labour market and wider economic conditions. But a further factor has been the increased costs to employers of providing defined benefit schemes for their employees – costs that partly resulted from a series of regulatory changes, mostly intended to improve protection for scheme members, including:

- the requirement to guarantee Limited Price Indexation<sup>2</sup> pension improvement; and
- the introduction of the Minimum Funding Requirement.

1.14 Defined benefit remains the dominant form of pension provision. Nevertheless, the trend for the foreseeable future is towards defined contribution.

## Structure of the pensions industry

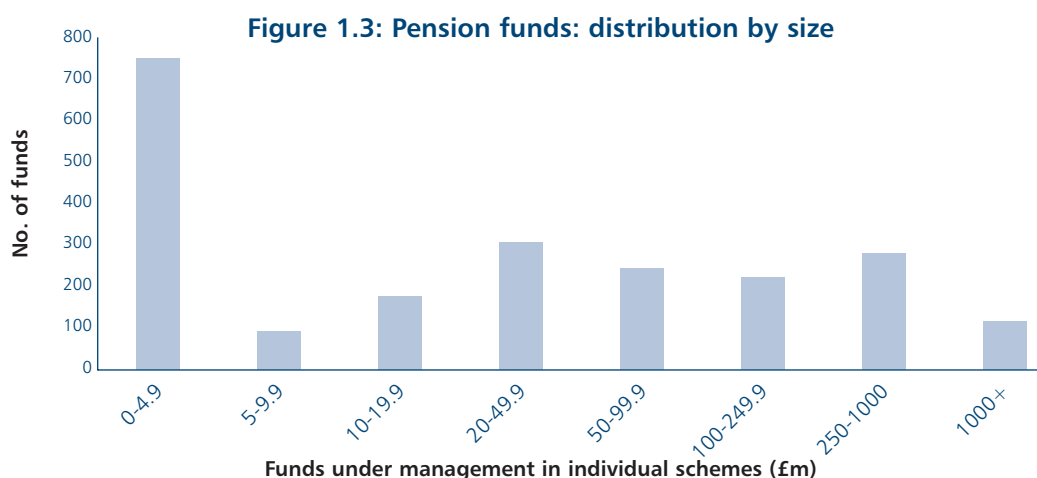
1.15 Table 1.2 shows some of the largest UK occupational pension funds, setting out the employers involved and the size of the funds.

**Table 1.2: Larger UK pension funds**

Fund	£ billion
BT	29.7
Coal Industry Pension Schemes	26.1
Electricity Supply Pension Scheme	22.0
Universities Superannuation Scheme	22.0
The Post Office	18.0
BG Group	13.2
Lloyds TSB Group	12.9
BP Amoco	12.5
Barclays Bank	11.4
Shell	11.4
British Airways	10.5
National Westminster Bank	10.0
Corus	9.1
ICI	7.6
HSBC	7.3
BBC	7.2
Strathclyde Pension Fund	6.7
Greater Manchester Pension Fund	6.1

Source: Information derived from NAPF Yearbook 2001.

1.16 Figures 1.3 and 1.4 further analyse the distribution of pension funds. The largest funds between them hold the bulk of pension fund assets. The majority of members of occupational pension schemes are in these schemes. There is then a long 'tail' of smaller schemes.

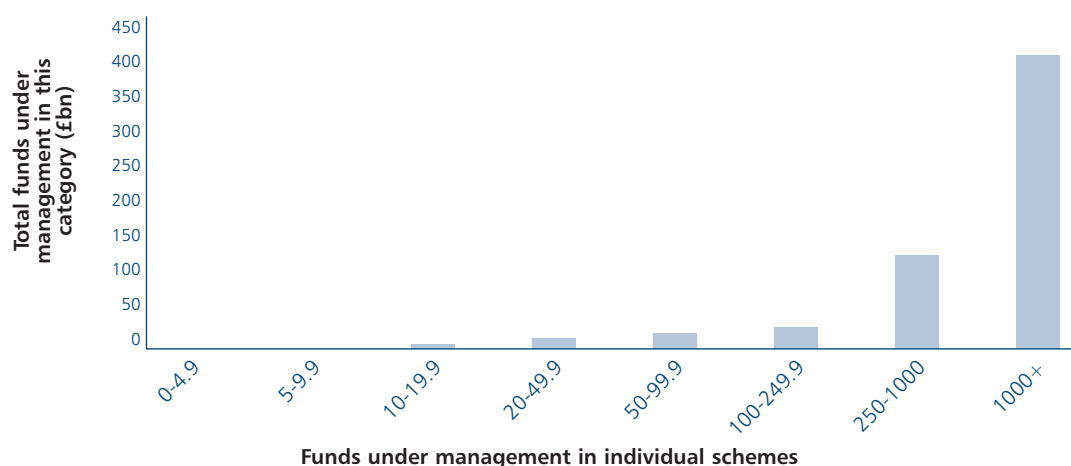


Source: 'Pensions pocket book 2000', NTC Publications Limited in association with Bacon & Woodrow.

<sup>2</sup> A change introduced in the Pensions Act 1995 requires the whole of an occupational pension (or the protected rights element of an appropriate personal pension) to be subject to Retail Price Indexation (RPI) or 5%, whichever is lower. This is known as Limited Price Indexation. The change was effective from 6 April 1997.



**Figure 1.4: Pension funds: distribution by funds under management**



Source: 'Pensions pocket book 2000', NTC Publications Limited in association with Bacon & Woodrow.

1.17 Table 1.3 sets out the distribution of scheme types in the private and public sector.

**Table 1.3: Types of scheme structure used by pension funds**

Type of scheme	Private sector schemes (%)	Public sector schemes (%)	All schemes (%)
Defined contribution (money purchase)	19	2.3	18
Defined contribution (group personal pension)	4.5	2.3	4
Defined benefit (final salary)	72	93	74
Hybrid	4.5	2.4	4

Source: Data taken from the NAPF Annual Survey 2000 (Twenty-Sixth Annual Survey of Occupational Pension Schemes): Information applies to the year ended March 2000

1.18 Almost all pension schemes have a trust structure, in which a trust independent of the sponsor company holds the assets of the scheme.<sup>3</sup> Trust law therefore exerts an important influence on pension funds. Specific pensions legislation, notably the Pensions Act 1995, also has a number of provisions relating to investment by pension funds.

1.19 The great majority of pension funds no longer manage their assets in-house, but contract out the management function to fund managers. The relationship between funds and their managers is therefore a crucial issue, as is the relationship between these two parties and the actuaries and investment consultants who advise pension funds. Later chapters analyse these relationships at length.<sup>4</sup>

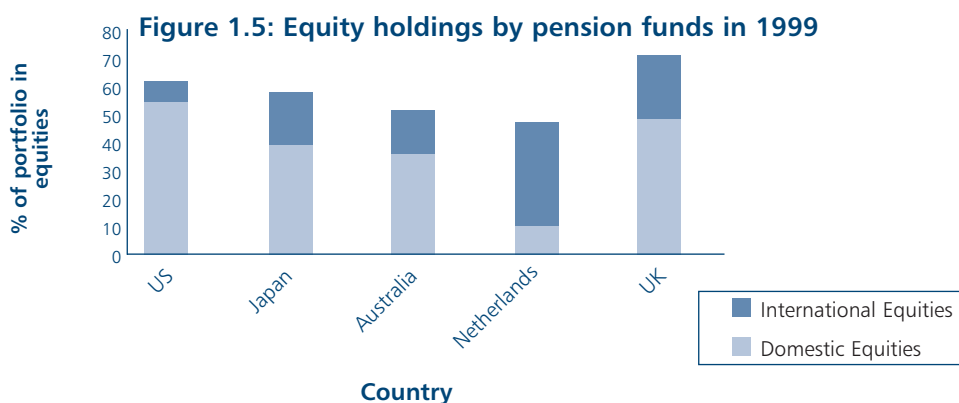
1.20 One further striking feature of the UK pensions industry has been its willingness to invest in equities. It did this at an early stage – the move to equities began in the 1950s – and it remains more heavily invested in equities than most foreign comparators<sup>5</sup> (see Figure 1.5). Moreover, as Figure 1.6 shows, the trend over the years has been for allocations to equities

<sup>3</sup> 15 per cent of occupational schemes – usually the smallest – are managed by insurance companies under commercial contracts. In these, the insurance company takes responsibility for all aspects of the scheme, including administration.

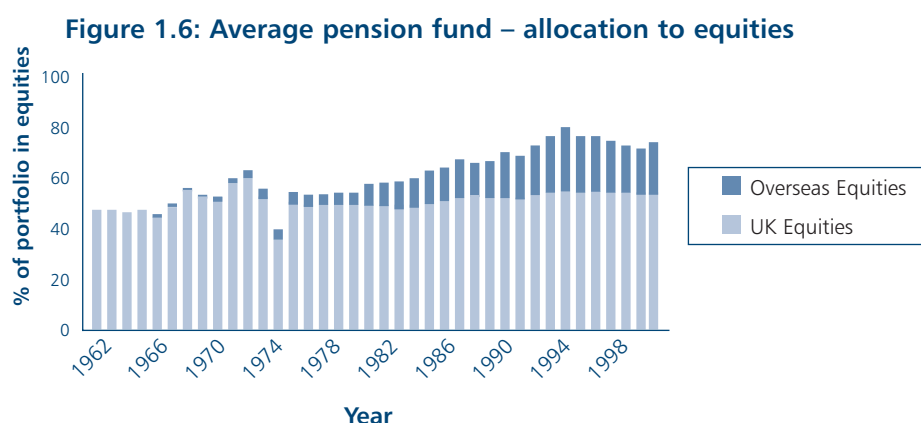
<sup>4</sup> See in particular Chapters 3, 4 and 5.

<sup>5</sup> The move to equities was earlier in the US but not as marked as in the UK.

to continue to increase. This has largely been a result of the high historic levels of inflation in the UK – as inflation rose, fixed interest securities became less appealing, with investors choosing to invest in equities instead, in the pursuit of real returns. Strong historic equity returns appear to have encouraged investors to remain invested in equities despite inflation having fallen over more recent years.



Source: Phillips & Drew, 'Pension Fund Indicators, a long-term perspective on pension fund investment 2000', p.12.



Source: Phillips & Drew, 'Pension Fund Indicators, a long term perspective on pension fund investment 2000', p.18.

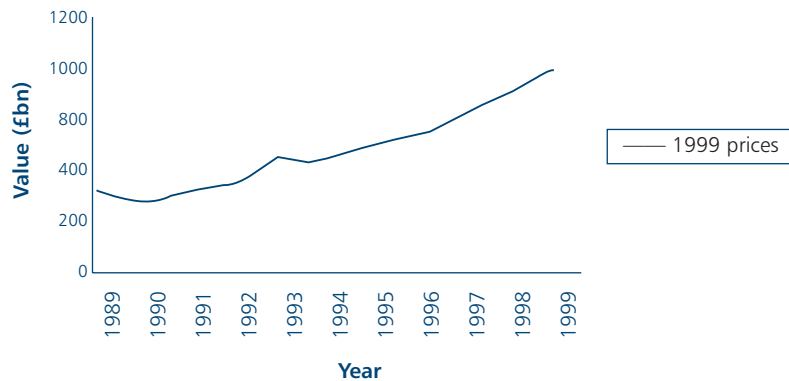
## Life insurance

- 1.21 In 1999, UK insurers had £1.1 trillion of assets.<sup>6</sup> The life insurance business accounted for £977 billion of this. (The remainder belonged to general insurance, which the review has not examined.)
- 1.22 Life insurance assets have also shown strong growth historically. Between 1989 and 1999, investment holdings increased from £388.4 billion<sup>7</sup> to £977 billion. This growth is shown in Figure 1.7.

<sup>6</sup> Figures from the Association of British Insurers (ABI).

<sup>7</sup> Valued at 1999 prices.

**Figure 1.7: The growth of life insurance assets 1989-1999**



Source: ABI, 'Insurance Statistics Yearbook', 1989-1999.

- 1.23 Life insurance in its original sense offers a means of providing for a policyholder's dependants in the event of the policyholder's death. In return for regular premiums, the insurer pays a lump sum on death. Life insurance helps to provide for the surviving family and can also be used as a form of inheritance planning.
- 1.24 In practice, however, most of the business undertaken by life insurance companies is effectively savings and investment business. There are a number of reasons for this:
- life insurance shares with savings and investment a common theme of providing for the future by the regular payment of small sums of money;
  - in the past, life policies offered policyholders significant tax advantages;
  - the with-profits policy, the traditional form of life insurance investment, offers both diversification and some protection from market downturns, providing reassurance for customers nervous of equity markets; and
  - from the life office's perspective, the need to manage a large pool of premiums over long periods of time leads naturally to involvement in investment issues.

### ***Types of life insurance***

- 1.25 Life companies offer a wide range of different products, which fall into two broad categories of investment:
- linked investments, so-called because the amount invested is linked directly to the investment performance of certain assets. They are effectively the insurance equivalent of unit trusts, and often require the retail consumer to make some asset allocation decision;
  - non-linked, for example, with-profits investments. Individuals' with-profits investments are pooled together with the life insurer's own funds and invested in a range of asset classes. Instead of receiving investment growth directly linked to the performance of the pooled funds, the individual receives an annual bonus and a discretionary terminal bonus as determined by the product provider.

### ***Structure of the life insurance industry***

- 1.26 The major life companies are set out in Table 1.4. The traditional structure for a life company was a mutual one. This form of ownership has come under considerable strain as companies have consolidated across borders and between different areas of financial services. Policyholders, too, have exerted pressure for demutualisation. Nonetheless, the life insurance industry remains dominated by companies with long histories – often several centuries old. This partly reflects the early emergence of life insurance as a business, but it also underlines the importance of an accumulated capital base in the industry.

**Table 1.4: Major life insurance companies 1999**

<b>Group</b>	<b>Assets (£bn)</b>	<b>Share (%)</b>
Prudential	113.2	12.8
Legal & General	93.7	10.6
CGNU	88.1	9.9
Standard Life	61.4	6.9
Lloyds TSB	58.0	6.6
AXA	44.1	5.0
AMP	37.6	4.2
Zurich Financial Services	35.4	4.0
Equitable Life	32.6	3.7
RSA	29.7	3.4
Friends Provident	29.2	3.3
Barclays	27.5	3.1
Halifax	23.3	2.6
Aegon	21.3	2.4
CIS	19.7	2.2
Royal London	17.2	1.9
Britannic Assurance	14.7	1.7
Abbey National	14.7	1.7
Scottish Life	9.1	1.0
Scottish Provident	8.7	1.0
Sun Life Of Canada	8.6	1.0
National Westminster Life	8.2	0.9
Windsor	7.2	0.8
Canada Life	6.9	0.8
Skandia	5.8	0.7

Source: ABI.

- 1.27 Unlike occupational pension funds, life insurance companies compete in commercial markets, selling to retail customers in most cases (except for certain kinds of pensions business). They are therefore strongly influenced by commercial considerations – profitability, competition and so on.
- 1.28 Regulatory influences are also very important. Life companies have an appointed actuary who must be satisfied at all times that the company’s financial position is satisfactory. The actuary is also the guardian of policyholders’ ‘reasonable expectations’.<sup>8</sup> In addition, European directives have led to a series of regulations designed to meet the general requirement for a margin of solvency – that assets should exceed liabilities by a suitable amount. These are discussed in Chapter 9.

## **Pooled investment vehicles and other institutional investments**

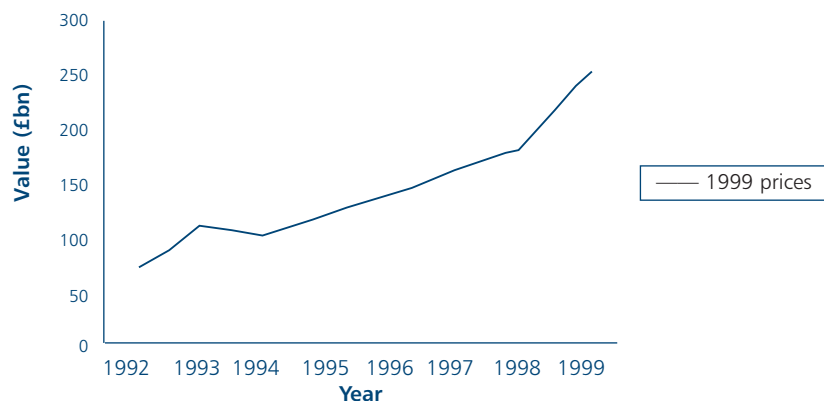
- 1.29 Pooled investment vehicles together form a third, somewhat smaller, category of institutional investment. They fall into three main groups:
- unit trusts;
  - oeics; and
  - investment trusts.

<sup>8</sup> See box on policyholders’ reasonable expectations in Chapter 9.

## Unit trusts and oeics

- 1.30 Unit trusts are collective investment schemes constituted under the terms of a trust deed. Oeics are similar in nature, except they take a corporate rather than a trust form. Viewed as a hybrid investment vehicle, they have some of the features of a company and some of the features of a unit trust. Both are open-ended, which means they can expand or contract to meet demand for units/shares. While there are some differences in regulatory treatment, most of these are in the process of being harmonised.
- 1.31 Unit trusts and oeics overlap with other categories of institutional investment in a number of ways:
- from the end-customer's point of view, a unit trust/oeic is often indistinguishable from a linked product (a unitised life fund) sold by a life insurer. Although in regulatory terms they are distinct, the two products can compete directly;
  - although unit trusts/oeics are themselves institutional investors, their end-investors are often other institutions such as pension funds or life assurance companies; and
  - unit trusts/oeics are typically managed by fund managers, who simultaneously manage money on behalf of pension funds and insurance companies.
- 1.32 As Figure 1.8 shows, funds under management in authorised unit trusts and oeics have grown rapidly over time.

**Figure 1.8: Growth in authorised funds under management**



Source: Association of Unit Trusts and Investment Funds (AUTIF).

## Types of unit trust and oeic

- 1.33 Unit trusts can be *authorised*, in which case they are regulated by the FSA, or *unauthorised*:
- authorised unit trust schemes may be promoted to the public, and are subject to regulation under the Financial Services (Regulated Schemes) Regulations 1991;
  - unauthorised unit trusts which are not covered by these regulations may not be promoted to the public.<sup>9</sup> Unauthorised unit trusts are used mainly as vehicles for institutional investment and may benefit from special tax treatment from the Inland Revenue.

Oeics cannot currently exist in unauthorised form, and are regulated by the Financial Services (Open-Ended Investment Companies) Regulations 1997.

<sup>9</sup> Except to the extent permitted under the Financial Services (Promotion of Unregulated Schemes) Regulations 1991, which allows their sale to high net worth individuals under certain circumstances.

- 1.34 Within the authorised category of unit trust, various types of unit trust are set out in the regulations – securities funds, umbrella funds, funds of funds and so on, and similar categories are set out for oeics. The detailed distinctions are not especially significant for the purposes of this review.

### **Structure of the unit trust industry**

- 1.35 The largest unit trust/oeic managers are set out in Table 1.5. The main companies in this area have historically been fund management groups.

**Table 1.5: Largest unit trust/oeic managers (November 2000)**

<b>Name</b>	<b>Total funds under management (£billion)</b>
Fidelity	16.4
Schroder	12.6
Threadneedle	11.3
M&G	10.8
Gartmore	9.9
Perpetual	9.6
Scottish Life	8.8
Merrill Lynch	8.0
Scottish Widows	7.4
Barclays	6.3
Aberdeen	6.1
HSBC	5.9
Friends Provident	5.8
Jupiter	5.3
Invesco GT	5.3

Source: AUTIF.

### **Investment trusts**

- 1.36 Investment trusts are closed-ended investment vehicles<sup>10</sup> that take the legal form of a company. They have fixed issued share capital<sup>11</sup> and are traded on the London Stock Exchange. An investment trust has a team of salaried staff or, more commonly, contracts the services of a specialist fund management company. As companies that invest in the shares of other companies, they have a part to play in institutional investment. It has been estimated that two-thirds of investment in investment trusts is itself institutional.

- 1.37 Figure 1.9 sets out the growth in this sector since 1992, both in terms of total assets and market capitalisation.

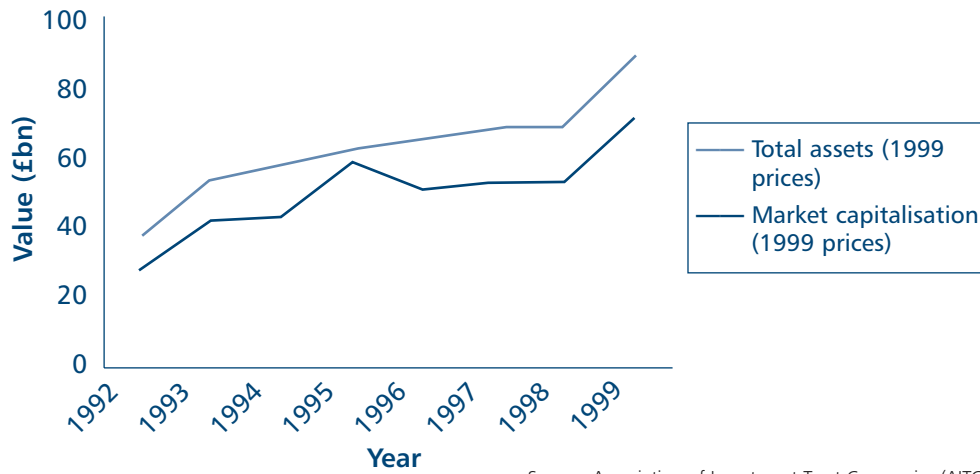
### **Types of investment trust**

- 1.38 Varying types of investment trust have emerged in recent years. Although traditionally investment trusts have issued ordinary shares, an increasing number now utilise split-level capital structures. These are issued for a fixed term of, say, seven or twelve years, after which the trust is wound up and assets distributed. The trust issues several classes of shares, each with its own entitlement to part of the investment returns of the fund (for example, income shares entitle the holder to receive income during the life of the trust, whereas capital shares receive no income, but receive residual assets when the trust is wound up).

<sup>10</sup> This means that, unlike unit trusts and oeics, when shareholders wish to sell their shares, the investment trust is not usually involved. The transaction takes place in the market instead. Similarly, when purchasers buy shares, they will normally buy existing shares on the market.

<sup>11</sup> Although investment trusts have fixed issued capital, like all companies, they are able to issue more shares and buy-back their own shares for cancellation under certain circumstances. Many investment trusts over recent years have taken advantage of their ability to buy-back shares to address the issue of shares trading at a discount to net asset value.

**Figure 1.9: Market capitalisation and total assets of investment trust industry**



- 1.39 Investment trusts also offer a range of specialist sector funds, including venture capital and development funds.
- 1.40 In contrast to unit trusts and oeics, investment trusts are not regulated. They are listed companies subject to company law and listing requirements. They are authorised by the Inland Revenue for tax purposes.

### **Structure of the investment trusts industry**

- 1.41 The largest investment trusts are set out in Table 1.6.

**Table 1.6: Largest investment trusts**

Trust Name	Manager	Total Assets (£m)
Foreign & Colonial	Foreign and Colonial	3126
Witan	Henderson Global Investors	2051
Alliance	Alliance	2020
Scottish Mortgage	Baillie Gifford	1918
Edinburgh Investment	Edinburgh	1797
Scottish Investment Trust	Scottish Investment Trust	1569
Fleming Mercantile	Chase Fleming	1157
Monks	Baillie Gifford	923
RIT Capital Partners	Rothschild J	840
Merrill Lynch European	Merrill Lynch	835
Fleming Japanese	Chase Fleming	823
Murray International	Murray Johnstone	770
Fleming Overseas	Chase Fleming	749
Govett Strategic	Govett	722
TR European Growth	Henderson Global Investors	710

Source: Fundamental Data.

### ***Other institutions***

1.42 There are also a number of smaller categories of UK institution. These include:

- those charities with significant funds to invest, as well as the wider category of endowments, not all of which are necessarily registered charities; and
- banks. Unlike some continental economies and Japan, banks in the UK tend not to be significant shareholders in their own right.

1.43 The remainder of this report focuses on the largest pools of funds identified in this chapter: pensions and life insurance, and to a lesser extent, pooled investment vehicles (namely unit trusts, oeics and investment trusts).



## CHAPTER 2:

# Pension Funds: the Context for Investment Decision-making

## Introduction

2.1 Pension funds' investment decision-making involves three principal groups:

- the trustees of the fund;
- their investment consulting and actuarial advisers; and
- the fund managers to whom they delegate.

2.2 While they can and do both delegate investment decisions and rely on investment advice, trustees are nonetheless the ultimate decision-makers for occupational pension funds. The analysis of the review therefore begins, in this chapter, with them.

2.3 The purpose of the chapter is to map out the skills and resources which trustees bring to investment decision-making, and to understand the incentives, primarily legal ones, which act on them. It therefore:

- sets out the findings of a survey of trustees commissioned by the review;
- analyses the legal environment in which trustees make their decisions, focusing in particular on what requirements the law makes of trustees with regard to investment decision-making;
- considers the impact of industry practice on training and the relationship with the sponsor; and
- makes some recommendations about the management of pension funds, covering issues such as the establishment of an investment committee, the payment of trustees and the relationship with the sponsor.

2.4 Following chapters complete the description by looking at:

- the structures used by pension funds to make investment decisions;
- the investment consulting industry;
- the fund management industry;
- issues specific to defined contribution schemes;
- pension fund surpluses; and
- the Minimum Funding Requirement (MFR).

## Survey of trustees: results

2.5 Trustees act as the ultimate decision-makers for pension funds. Even though they delegate certain investment responsibilities to others, they still define the framework and objectives. Understanding their role is crucial to understanding why pension funds invest in the way they do.

- 2.6 The review therefore commissioned a survey of trustees of pension funds. This included interviews with 226 trustees and 75 scheme administrators from a representative sample of pension funds of varying sizes.<sup>1</sup> Some of the key findings are as follows.
- 2.7 Many trustees currently bring very limited time and expertise to their investment responsibilities:
- 62 per cent of those surveyed had no investment qualifications;
  - 26 per cent received less than one day's training when they first became trustees, and 69 per cent received 2 days or less;
  - 54 per cent said they had no investment committee or in-house professionals to help them on investment matters;
  - 44 per cent of trustees have not attended any courses since their initial 12 months of trusteeship; and
  - 49 per cent of trustees spend three hours or less preparing for pension investment matters before a trustee meeting.
- 2.8 The results also suggest that most trustees do not have extensive knowledge of investment issues, and in particular do not have detailed knowledge of issues relating to their own funds. Of funds with a scheme-specific benchmark, 23 per cent of trustees said they did not know what their benchmark was.
- 2.9 Moreover, when asked factual questions about the management of their fund, substantial minorities of trustees gave answers that disagreed with responses from the same fund's administrator. The main differences concerned:
- whether the fund employed one investment manager or several (40 per cent disagreement); and
  - whether it employed segregated funds, pooled funds, or both (60 per cent disagreement).
- 2.10 These results are perhaps not particularly surprising. Similar impressions were repeatedly given to the review by fund managers, consultants and trustees. Responses to the review's consultation document also confirmed the results of the survey. For instance:
- 'trustees are part-time and generally not experienced in investment matters.'*
- 'We are concerned that they (trustees) may not have a sufficient breadth of investment knowledge to be able to complement the views put forward by the consultants.'*
- 2.11 The pattern is not uniform. Some funds, particularly larger funds, have successfully built up considerable levels of expertise among their trustees. But the survey and the review's investigations suggest that these are a minority.
- 2.12 The rest of this chapter considers the extent to which this situation results from legal structures and industry practice.

## The trust structure

- 2.13 Most UK pension funds are organised as trusts.<sup>2</sup> A trust is a legal vehicle that places the responsibility for taking care of certain property in the hands of a third party – in the case of pensions, a board of trustees:

<sup>1</sup> The methodology for the survey, the full results, and the questionnaire are set out in Appendix A.

<sup>2</sup> Many of the early UK company pension schemes (e.g. all the railway schemes) were established under statute law. Today UK Local Authority Schemes remain as statutory schemes (all are covered by one set of legislation). However, the model on which they are based is a trust model, and the regulations state that they are to be run as if they were trusts (see Appendix B).

*'A trust is an equitable obligation binding a person (who is called a trustee) to deal with property over which he has control (which is called the trust property), for the benefit of persons (who are called beneficiaries...), of whom he may himself be one, and any one of whom may enforce the obligation. Any act or neglect on the part of a trustee which is not authorised or excused by the terms of the trust instrument, or by law, is called a "breach of trust".'*<sup>3</sup>

2.14 When an employer decides to provide a pension for its employees from a segregated fund<sup>4</sup>, the trust structure has a number of advantages:

- a trust is a separate legal entity. This means that the assets it holds are entirely separate from the sponsoring company and its creditors;
- as trustees are obliged to act solely in the interests of the beneficiaries on whose behalf the assets are held, a trust is a means of protecting those beneficiaries;
- a board of trustees can provide common ground between different interest groups (employees, the sponsor company and so on) because each can nominate trustees; and
- the Finance Act 1921 specified the trust structure as a prerequisite for granting tax relief on pension benefits (so that tax-exempt assets are not available to the employer).<sup>5,6</sup>

## Incentives on trusts and trustees

2.15 The next issue concerns the incentives governing trusts and their individual trustees. In particular, to what extent do these either cause or compensate for trustees' lack of investment expertise?

### ***The governing sources of law***

2.16 The primary incentives governing pension funds are legal. While sponsors can and do have an interest in effective investment, the trust structure sets out deliberately to create distance between sponsors and trust, so these incentives act on trusts only at second hand.

2.17 The objectives and responsibilities of a pension trust are defined in three sorts of regulation:

- its trust deed. Each pension fund has a trust deed setting out the trust's parameters. There will also be a set of rules governing the operation of the trust. The trust deed, together with the rules, acts in effect as the scheme's constitution. Within the overriding context of statute and common law, it constrains trustees' actions;
- general trust law. This has a very long history. Much of it has been established by case law, although the Trustee Act 1925<sup>7</sup> is relevant; and
- specific pensions legislation: principally, the Pension Schemes Act 1993 and the Pensions Act 1995 (intended to codify much of pensions law), as well as fiscal legislation and its attendant regulations.

<sup>3</sup> Underhill and Hayton, *Law of Trusts and Trustees*, Butterworths, Fifteenth Edition, 1995, p.3.

<sup>4</sup> As opposed to holding the liabilities on the company balance sheet, as traditionally done, for instance, in Germany.

<sup>5</sup> It is possible to promise a pension without pre-funding, in which case there will be no tax relief for the contributions and no absolute need to establish a trust. Such a scheme may be offered to highly paid individuals as an Unfunded Unapproved Retirement Benefit Scheme or as a Funded Unapproved Retirement Benefit Scheme. We are not concerned with these as they affect a very small number of highly paid individuals.

<sup>6</sup> To obtain tax exemption a scheme has to seek approval from the Pension Schemes Office of the Inland Revenue. The Inland Revenue imposes limits on the benefits that may be obtained with tax relief and also on the amounts that can be contributed each year.

<sup>7</sup> This is now supplemented by the Trustee Act 2000.

2.18 The Financial Services Act 1986 and its successor, the Financial Services and Markets Act 2000, also have an important impact on investment decision-making by pension funds. These prohibit persons not authorised under the Act from carrying on an investment business. As the great majority of trustees or trusts are not authorised under the Act, the prohibition implicitly defines what they are permitted to do.

### ***Responsibilities of individual trustees***

2.19 The trust structure gives trustees a clear responsibility towards the scheme's beneficiaries. This is one of its attractions. Under common law, the general legal requirements of trustees are:

- to act in good faith (to be honest and without ulterior motive; to give effect to the trust instrument; to act as a prudent and reasonable man);
- to exercise their own discretion (receiving advice in a formal manner); and
- to act in the best interests of the beneficiaries. Case law states that:

*'when the purpose of the trust is to provide financial benefits for the beneficiaries, as is usually the case, the best interests of the beneficiaries are normally their best financial interests.'*<sup>8</sup>

2.20 The crucial question of the level of expertise required by trustees in pursuit of this objective is the subject of case law. A helpful formulation is that:

*'it is the duty of a trustee to conduct the business of the trust with the same care as an ordinary man of business would extend towards his own affairs.'*<sup>9</sup>

2.21 In addition, different standards may be expected according to whether a trustee is a lay trustee or a professional trustee. The case cited by the Law Commission is *Jobson v Palmer* [1893]. This is reflected in the definition in the Goode Report, according to which the trustees must:

*'exercise, in relation to all matters affecting the fund, the same degree of care and diligence as an ordinary prudent person would exercise in dealing with property of another for whom the person felt morally bound to provide and to use such additional knowledge and skill as the trustee possesses or ought to possess by reason of the trustee's profession, business or calling.'*<sup>10</sup>

2.22 This is a crucial point: even according to the latter opinion, there is no suggestion that trustees have any duty to equip themselves with expertise beyond *that which they possess by virtue of their own profession*. A pension fund trustee whose professional life does not involve any investment or financial expertise is not required to gain any such expertise in order to fulfil the duty of acting in the best interests of the fund's beneficiaries. Rather, the obligation is to obtain advice and information, and then to do the best he or she can.

2.23 This is extremely important and fundamental to the review's analysis and recommendations. Trustees have no legal (or, in many cases, commercial) incentive, nor any duty, to become educated in investment matters.

<sup>8</sup> *Cowan v Scargill* [1985] Ch270 at p.287 (the so-called 'Megarry judgment').

<sup>9</sup> *Bartlett v Barclays Bank* (No.1) [1980] Ch 515 at p.531, per Brightman J. See also the discussion in *Pension Law Reform. The Report of the Pension Law Review Committee*, HMSO, 1993 (the Goode Report), paragraph 4.9.7.

<sup>10</sup> Goode Report, paragraph 4.9.7.

2.24 Judged historically, this is not entirely surprising. Trusts were originally devised to manage the affairs of people who, for various reasons, could not do so competently for themselves – they were minors; they were seriously ill; there were too many of them and so on. In essence, a trust was designed as a structure to manage matters on their behalf more or less as they would have done themselves, had they been able to. Trust law was not designed to introduce the expertise likely to be required in the management of substantial pools of pension assets.

### **Recruitment of trustees**

2.25 Prior to the Pensions Act 1995, no specific legislation laid down who might become a trustee or how they might be chosen. The Pensions Act 1995 introduced a requirement that members should have the right to nominate one-third of trustees.<sup>11</sup>

2.26 Respondents to the review's consultation document were divided over the possible effects on investment decision-making of this new requirement. In particular, did the desire to bring in more trustees with an understanding of beneficiaries' needs increase the likelihood that trustees would lack investment expertise? One respondent argued, for example, that:

*'The member-nominated trustee provisions of the Pensions Act 1995 have resulted in an increase in the number of inexperienced trustees, who are unlikely to be investment experts.'*

A contrary view suggested that:

*'recent Government measures to promote member-nominated trustees have been very positive. There is no evidence to suggest that professionally qualified trustees would have produced better investment returns.'*

2.27 The review does not accept that lack of investment expertise is an inevitable result of increasing the proportion of member-nominated trustees.<sup>12</sup> It does, however, view the lack of investment understanding among trustees in general as a serious problem.

### **Independent professional trustees**

An independent trustee is defined as a person who has no connection with the employer and is not a beneficiary of the occupational pension scheme. In some trust deeds and rules the independent trustees are given special powers. The Occupational Pensions Regulatory Authority (Opra) also has the power to appoint independent trustees in certain circumstances.

Some schemes will have made provision for such trustees in their trust deeds and rules. There have always been a number of individuals – lawyers and actuaries, for example – who become independent trustees.

In the past decade – particularly after the Maxwell affair – the practice of turning to corporate trustees has also increased. In this instance, the pension fund has a commercial arrangement with a company specialising in providing trustee services, which provides a suitably qualified individual to serve on the board.

The review believes that the use of independent professional trustees is a helpful and positive development.

<sup>11</sup> This was to ensure that trustees had as good an understanding as possible of the interests and concerns of beneficiaries – not so that different trustees should 'represent' different interests.

<sup>12</sup> At the same time as the number of member-nominated trustees has increased, so has the practice of introducing 'independent' or 'expert' trustees, who are paid (see box).

2.28 The review wishes to encourage a culture in which pension fund governance is carried out in a business-like manner. Specifically:

**The review recommends that trustees should assess the effectiveness of their own contribution to meeting the objectives of the fund as they do that of their advisers and fund managers, considering issues such as:**

- **whether or not the decision-making structures they have in place address the task of effectively running their fund;**
- **whether their division of time between their various responsibilities is right;**
- **whether they have the right mix of skills and experience collectively; and**
- **whether the fund's control environment is fit for purpose.**

2.29 The process of producing the Statement of Investment Principles (SIP), strengthened as the review recommends in Chapter 11, should provide an opportunity for trustees to look at these issues. This is discussed further below.

2.30 Furthermore, the review believes that, in general, paying trustees for the performance of their duties is good practice. Their task is a serious and complex one, the effective completion of which requires considerable time and energy, and should be rewarded.<sup>13</sup>

**The review recommends that it is good practice to pay trustees, unless there is a specific reason why this may be unnecessary (for instance where they are senior executives of the sponsor company).**

2.31 The review also proposes that the law relating to pension fund trustees' level of skill be amended, so that it should no longer be sufficient for them to exercise the skill and prudence of an 'ordinary man of business'.

**The review proposes that there should be a legal requirement that where trustees are taking a decision, they should be able to take it with the skill and care of someone *familiar with the issues concerned* (see box overleaf). If they do not feel that they possess such a level of skill and care, then they should either take steps to acquire it, or delegate the decision to a person or organisation who they believe does possess this level of skill and care.**

2.32 It should be clear that this proposal does not attempt to prescribe the level of decision that trustees should or should not take, nor the person or organisation to whom they should delegate. Trustees will remain free to take the decisions they are taking now. But if they do so, they must ensure that they have the necessary competencies.

2.33 The review does not believe that this proposal would or should mean the end of the appointment of member-nominated trustees, or that it would effectively mandate that all trustees must be professionals. Nor does the review believe this would be desirable. Trusts would be able to employ a mixture of strategies to fulfil the requirements above, including:

- strengthening the capability of the trustee body through the recruitment of internal staff and through training of trustees;
- focusing this expertise through delegation of detailed discussions of investment to an investment subcommittee; or

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<sup>13</sup> The current legal situation is that there is no general prohibition against trustees being paid to fulfil their duties, although this requires a specific authorisation in the deed, or a statutory right (such as in the case of an independent trustee following insolvency).

- delegating decisions to outside managers.

2.34 Chapter 11 considers how the proposals above and others relating to pension fund management could be put into practice.

### **‘Familiar with such matters’**

The revised requirement proposed by the review is similar to that required in the US, under the Employment Retirement Income Security Act 1974 (ERISA). This federal legislation codifies traditional fiduciary responsibilities into a single nationwide standard. Although Government plans and some others are exempt from ERISA, the rules governing them are generally similar in effect.

Under ERISA each pension fund must have one or more named fiduciaries, designated as responsible for operating it. The fiduciary person may be the trustee, the plan administrator, the employer/plan sponsor, or the investment adviser.

Section 3(21)(A) of ERISA defines a fiduciary as a person or entity that ‘exercises any discretionary authority or discretionary control respecting management of such plan’. The primary section of ERISA which deals with fiduciary responsibilities is Section 404. Section 404 provides standards amounting to how a fiduciary should act.

Federal regulations issued by the Department of Labor define the duties of fiduciaries as follows:

‘a fiduciary shall discharge his duties with respect to a plan with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting *in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.*’<sup>14</sup>

The reference to ‘like capacity and familiar with such matters’ is sometimes referred to as the ‘prudent expert’ rule.

### ***Trustees’ specific investment responsibilities***

2.35 General trust law and the requirements created by it are not, of course, the only relevant legal constraints on pension fund trustees. Occupational pensions have a particularly difficult combination of characteristics:

- potentially a very large number of beneficiaries;
- money which is of extreme personal importance to them (retirement income);
- in many cases, very large sums of money for the fund to manage;
- a complex structure of liabilities; and
- long time horizons.

2.36 Recognising that general trust law can be insufficient to deal with these matters, the pensions reforms of the 1990s sought to tackle some of them directly. However:

- the basic thrust of the reforms was to protect beneficiaries from gross incompetence or mismanagement by the trustees – that is, a failure to carry out the most basic duty of acting in the best interests of beneficiaries. The dangers they were seeking to address

<sup>14</sup> Department of Labor, 44 FR 37225, June 26, 1979 [review emphasis].

included improper access to the fund's assets by the sponsor; wildly inappropriate investment of its assets; unjust removal of benefits entitlements and so on. The focus was not on effective investment; and

- the continuing use of the trust form meant that all subsequent requirements on pension funds continued to rest on the basic legal assumption of the trust vehicle: namely, that it was seeking to create an equivalent to ordinary people managing their own affairs.

2.37 Furthermore, the requirements in pension law setting out how trustees should carry out their investment duties are mostly concerned with the processes of investment rather than the outcomes.

2.38 Trustees have the power to make investments as if they owned the assets. The Pensions Act 1995 states:

*'The Trustees of a trust scheme have, subject to any restriction imposed by the scheme, the power to make an investment of any kind as if they were absolutely entitled to the assets of the scheme.'*<sup>15</sup>

2.39 In making these investments, trustees are required to:

- invest prudently;
- invest in a diversified manner;
- prepare a SIP; and
- take written advice on the preparation of the SIP and proper advice on whether investments are satisfactory.<sup>16</sup>

2.40 The SIP has to include:

- the trustees' policy for complying with section 36 of the Act (this requires the trustees or fund managers to have regard, in choosing investments, to the need to diversify and to the suitability of proposed investments);
- the policy for complying with the Minimum Funding Requirement (MFR);
- the principles for the investment of the fund, including types of investment risk and expected return; and
- the trustees' policy (if any) on socially responsible investment and their policy on voting their shares.

2.41 In practice these requirements leave much scope for interpretation. Examples of SIPs run from one or two pages, virtually identical to the statutory list, to over 40 pages of very detailed principles and guidelines. The SIP represents a valuable step towards formalising a fund's policies on a number of important issues. It may also inhibit the worst sorts of mismanagement, such as investing in very high-risk assets or too heavily in cash. But as it is presently constituted, the SIP will not by itself promote proper discussion of the fund's investment strategy.

**The review recommends that the SIP should be strengthened so that members gain access to better quality information as a matter of course, and that it should be sent out to members annually.**

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<sup>15</sup> Pensions Act 1995, section 34 (1).

<sup>16</sup> Pensions Act 1995, sections 35 & 36.



2.42 The review concludes that while the investment-related provisions of pensions regulation are helpful, they are not themselves sufficient to compensate for many trustees' lack of investment expertise. In particular, the requirement for funds to take advice and trustees' understanding of this is crucial. The role of advisers is considered more fully in subsequent chapters.

## ***Advice and delegation***

2.43 Advice is covered by the Pensions Act 1995. Section 36(3) requires that except when trustees are investing in government securities they must take proper written advice, before investing, from a suitably qualified person or, for relevant investments, from a person authorised under the Financial Services Act 1986. They must renew that advice at intervals. Trustees must also take advice, and consult the employer, before preparing or amending the SIP.

2.44 In addition, the Pensions Act 1995 gives trustees a statutory power to delegate their investment duties.<sup>17</sup> If they do so, they are 'not responsible for the act or default of any fund manager in the exercise of any discretion delegated', providing they have taken 'reasonable steps' to satisfy themselves that the fund manager has the appropriate knowledge and experience.<sup>18</sup>

2.45 In practice, pension fund deeds also contain a power to delegate. The review has been advised that under modern trust law it is likely that a court would hold that there is an inherent power (even obligation) to delegate. Furthermore, pension trustees would in most cases be negligent and in breach of trust if they did not delegate matters such as legal advice and tax advice.

2.46 The trustees can also delegate their investment powers to a subcommittee of two or more trustees (although legally the trustees collectively remain responsible for the acts of this subcommittee). This feature of pension fund management is a positive and important one. Through recruitment and training, a sub-group of trustees with a good understanding of investment can be created, who can then take lead responsibility for investment decisions through the investment subcommittee. At the same time, the trustee board as a whole can continue to include a wide range of people, not all of whom have investment expertise.

**The review recommends that it is good practice for pension funds to have an investment subcommittee.**

### **Restrictions on trust investment**

The trust deed and rules of a pension fund may restrict some investment decisions – as may the SIP. For example, the possibility of investing in options, futures and other derivative instruments may be either absent or explicitly prohibited. Such a blanket prohibition is unhelpful. It appears to be based on a belief that derivatives are so inherently risky that a trust must be prevented from using them in any circumstances. In reality, of course, derivatives can be used to reduce as well as to increase risk.

While providing rules about how derivatives should be used is appropriate, creating blanket prohibitions on certain asset classes or instruments and thereby excluding them altogether from consideration is not a sensible approach to investment.

**The review recommends that trust deeds should not prohibit the use of particular instruments such as derivatives or prohibit investment in certain asset classes. Nor, other than with good reason, should SIPs or fund managers' mandates. Where they do contain unjustified prohibitions, they should be amended.**<sup>19</sup>

<sup>17</sup> Pensions Act 1995, section 34(2).

<sup>18</sup> Pensions Act 1995, section 34(4).

<sup>19</sup> At one time the Inland Revenue indicated that it might consider investing in derivatives as a trading rather than as an investment activity and thus subject it to tax. However, the Finance Act 1990 extended the definition in the Income and Corporation Taxes Act 1988 of tax-exempt investments held for the purposes of pension schemes specifically to include futures, contracts and options contracts.

## ***Liabilities of trustees***

- 2.47 The law lays potentially heavy liabilities on trustees. Under the Pensions Act 1995, trustees who commit a statutory breach may have to face either a civil fine or penalty, or even criminal prosecution.
- 2.48 Legislation allows a number of mitigating circumstances, however. Under the Trustee Act 1925, trustees will be excused a breach of trust if they have acted honestly and reasonably. Seeking legal or professional advice before acting may be held to demonstrate that they have acted reasonably. In addition, the trust deed and rules may provide for so-called exoneration clauses and the sponsor may provide indemnity insurance for the trustees.
- 2.49 Nevertheless trustees are likely to place a high priority on being able to demonstrate that there has been no breach of trust. Use of professional advisers is an important source of comfort in this respect.

## ***Regulation of pension funds***

- 2.50 Opra was set up under the Pensions Act 1995 and began operations when the Act came into force in April 1997. Among other things, it regulates trustees and can suspend, remove and disqualify trustees who are in serious breach of their duties, both under trust law and the specific duties set out in the Pensions Act 1995. It has no remit to look at issues of efficient investment. Much like the Pensions Act 1995 itself, it is essentially concerned to prevent gross incompetence or mismanagement by a trust.

## **Industry practice**

### ***Trustee training***

- 2.51 Trustees can take advantage of a range of training opportunities. The Pensions Management Institute (PMI) offers a one-hour examination for the Trustee Certificate of Essential Pensions Knowledge. A number of other bodies provide training for trustees, including the National Association of Pension Funds (NAPF), both nationally and at local level, fund management companies and consultancy firms. Trustees may also attend pensions conferences such as those organised by the NAPF and commercially, and there are also 'trustee circles' which meet to discuss issues of common interest.
- 2.52 Moreover, the Pensions Act 1995 provides that a sponsor must permit any employee who is a trustee of the sponsor's scheme to take time off for performing trustee duties and for 'undergoing training relevant to the performance of those duties'. The employee must be paid for the time taken off for these duties and for training.
- 2.53 However, there is no general requirement on pension fund trustees to obtain training or to update themselves regularly on changes in the law. Key findings about training from the survey of trustees carried out for this review are:
- 26 per cent of trustees received less than one full day's training in their first twelve months, and a further 17 per cent received only one day's training;
  - only 53 per cent of newly appointed trustees attended even a basic training course;
  - 44 per cent of trustees have not attended any courses since their initial 12 months of trusteeship; and
  - 49 per cent of trustees spend three hours or less preparing for pension investment matters before a trustee meeting.

2.54 The review believes that trustees' skill levels would be improved by increasing access to good quality training. This is entirely consistent with trustees managing their affairs in a more business-like manner.

**The review recommends that funds and their sponsors should increase their investment in training for trustees.**

### ***In-house staff and relationship with the sponsor***

2.55 Most pension fund trustees can rely on only a limited source of support from in-house staff. 77 per cent of trustees surveyed by the review had no in-house investment professionals assisting them in their work.

2.56 This is partly a result of the funds' relationship with their sponsor companies.

2.57 In principle, the sponsor of a pension fund should be a natural source of support, either by providing staff for the trust itself, or by providing its own competent staff to act as trustees. The sponsor has some financial and investment expertise. More importantly, it has the resources to purchase more. At the same time, its commercial incentives are essentially aligned with those of the fund. The more effective and efficient the fund's investment decision-making, the more cost-effectively the sponsor can provide pensions to its workforce.

2.58 Unfortunately, in practice the sponsor's potential to provide support is typically not fully realised. The legal framework set out in this chapter emphasises the separation of trust and sponsor. Policy continues to reflect the unspoken assumption that involvement by the sponsor is likely to be at the expense of members' interests and should be regarded with some suspicion.

2.59 This assumption has led to problems. It prompted the creation of a series of safeguards for members of defined benefit schemes, including inflation protection and the MFR. While the review gives high priority in its proposals on the MFR to safeguarding members' interests, this must be done with care. If the thrust of policy is simply to create distance between the sponsor and the scheme, then the sponsor is less likely to give the scheme the resources and help it needs – and may be more likely to want to close the fund and cease to offer defined benefit provision.

2.60 Regulation is not the only cause of distance between sponsor and fund:

- up to now the accounting treatment of pensions has tended to reduce the impact they have on company accounts, reducing the level of attention from corporate management;
- in organisational terms, the pension scheme is as likely to have been the responsibility of the human resources function of the company, as of the finance function; and
- the status of the surplus, which is considered in more detail in Chapter 7, has also had an important influence.

2.61 The review's proposals are intended to address these factors where possible. At the same time, it is clearly in sponsor companies' interests to ensure that their pension fund is well invested. The provision of resource – in particular, informed and skilled staff – has a key role to play in achieving that.

**The review recommends that sponsor companies should ensure that trustees have sufficient in-house staff to support them in their investment responsibilities.**

## Conclusion and recommendations

- 2.62 The basic objective set by the present legal structure of UK pension funds – to act in the best financial interests of beneficiaries – is sensible, and compatible with efficient decision-making. The specific duties imposed by pensions legislation, such as the requirement to diversify investment, are also compatible with efficient decision-making and form a necessary part of investment policy. No other parts of the general legal structures create outright obstacles to rational decision-making. (The MFR is considered in Chapter 8.)
- 2.63 At the same time, a number of legal and regulatory issues have important behavioural implications. These include:
- the basic tension between the complexity of a pension fund’s investment affairs and the governing assumption of trust law (that its purpose is to simulate the way ordinary people manage their own affairs rather than aiming for a higher level of expertise); and
  - the low minimum level of competence and effectiveness required by the provisions in the Pensions Act 1995 relating to investment.
- 2.64 **The review has therefore recommended in this chapter that:**
- **trustees should assess the effectiveness of their own contribution to meeting the objectives of the fund as they do that of their advisers and fund managers, considering issues such as:**
    - **whether or not the decision-making structures they have in place address the task of effectively running their fund;**
    - **whether their division of time between their various responsibilities is right;**
    - **whether they have the right mix of skills and experience collectively; and**
    - **whether the fund’s control environment is fit for purpose;**
  - **it is good practice to pay trustees, unless there is a specific reason why this may be unnecessary (for instance where they are senior executives of the sponsor company);**
  - **there should be a legal requirement that where trustees are taking a decision, they should be able to take it with the skill and care of someone *familiar with the issues concerned*;**
  - **if they do not feel that they possess such a level of skill and care, then they should either take steps to acquire it, or delegate the decision to a person or organisation who they believe does possess this level of skill and care;**
  - **the SIP should be strengthened so that members gain access to better quality information as a matter of course, and should be sent out to members annually;**
  - **it is good practice for pension funds to have an investment sub-committee;**
  - **trust deeds should not prohibit the use of particular instruments such as derivatives or prohibit investment in certain asset classes. Nor, other than with good reason, should SIPs or fund managers’ mandates. Where they do contain unjustified prohibitions, they should be amended;**
  - **funds and their sponsors should increase their investment in training for trustees; and**
  - **sponsor companies should ensure that trustees have sufficient in-house staff to support them in their investment responsibilities.**

# CHAPTER 3: Investment Decision-Making by Trustees

## Introduction

- 3.1 Chapter 2 set out the legal and organisational context in which pension funds make investment decisions. Within the trust structure it described, trustees have considerable discretion as to how the fund will be invested and managed. This chapter defines these various decisions, and discusses the two major approaches which trustees have taken to them – the peer group benchmark and the customised benchmark. It analyses the implications of these approaches for asset allocation, and the incentives they place on investment managers.
- 3.2 In particular, the chapter examines a number of issues around the practical implementation of the customised benchmark model, which is increasingly becoming the norm for pension fund management. Finally, it recommends a change in the level of familiarity which trustees are expected in law to demonstrate in respect of investment matters.

## Definitions

### *Types of decision to be taken*

- 3.3 Pension fund investment involves three broad areas of decision:
- asset allocation;
  - security selection; and
  - (where the first two functions are not carried out in-house) selection and monitoring of advisers and managers.

### *Asset allocation*

- 3.4 The review has a particular interest in asset allocation, given its remit to investigate whether there are factors encouraging institutional investors to follow industry-standard investment patterns. Asset allocation is by no means a precise term, as it refers to a pyramid of decisions of increasing specificity, which at the bottom end approach stock selection. In descending order, asset allocation can refer to:
- deciding on the overall split between real and monetary assets (broadly, equities and bonds);
  - dividing these into domestic and overseas fixed income and equities; and
  - further subdividing into specific segments, defined either by geography, sector, size or style.
- 3.5 Classifying assets is not an exact science:

*'Functional attributes play the dominant role in defining asset classes, with structural and legal characteristics taking secondary positions. Asset class distinctions rest on*

*broad sweeping differences in fundamental character: debt versus equity, private versus public, liquid versus illiquid, domestic versus foreign, inflation-sensitive versus deflation-sensitive. Ultimately investors attempt to group like with like, creating relatively homogeneous groups of investments.'*<sup>1</sup>

- 3.6 This arguably describes an ideal process: in reality, the influence of history and inertia can be considerable. Even where it is not, the exercise of judgement is important. This should be kept in mind when considering the current methods for carrying out asset allocation.
- 3.7 Asset allocation can also be tactical or strategic: again, there is a continuum, with no universally agreed dividing line between the two. Tactical asset allocation is generally thought of as referring to attempts to secure incremental return by exercising judgement within parameters set around the long-term or strategic allocation. This chapter is concerned with *strategic* asset allocation.

## Different approaches to investment decision-making

### ***Insured versus self-administered schemes***

- 3.8 The first distinction is between insured and self-administered schemes. In an insured scheme, the trustees insure the obligations of the pension fund through an insurance contract, and hand over responsibility for the scheme's management to the insurance company. Responsibility for investment decisions in these schemes therefore rests with the insurance company providing the service.<sup>2</sup>
- 3.9 In self-administered schemes, trustees retain responsibility for some aspects of investment. The scope of this responsibility depends on the approach used. A defining feature of self-administered schemes is the type of benchmark employed.

### ***Peer group total fund benchmark***

- 3.10 Under this model, the pension fund trustees delegate both asset allocation and security selection to a fund management company (possibly more than one) or other provider of investment management. Manager performance is measured by reference to what is believed to be a relevant peer group, and managers' objectives are similarly defined as being, for instance, to outperform the median or rank in the top quartile.

### ***Customised total fund benchmark***

- 3.11 The alternative model separates out the asset allocation decision from the security selection decision. Instead of delegating the asset allocation decision to a manager on the basis of a peer group benchmark, trustees first set their own asset allocation strategy. This will typically use an asset-liability model (described later in the chapter). They then give the assets to one or more managers to manage, defining the benchmark as either the relevant index for that asset class or classes, or basing the benchmark on peer group performance. These managers may be – but need not necessarily be – specialists in a particular market, with a mandate to invest only in that market; others may have more than one specialisation. The manager is therefore responsible for stock selection and for any tactical asset allocation, but not strategic asset allocation.

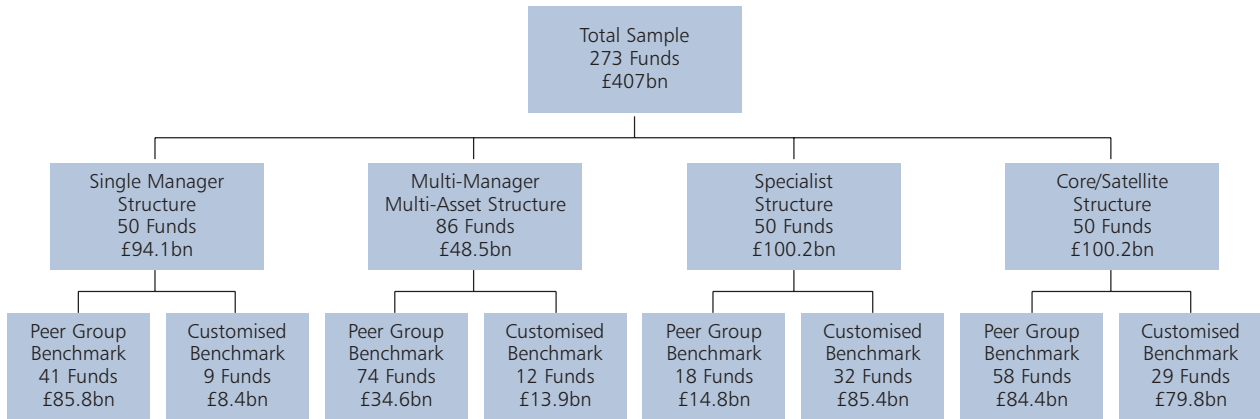
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<sup>1</sup> David Swensen, *Pioneering Portfolio Management*, The Free Press, 2000, p.102.

<sup>2</sup> Investing the funds by purchasing a balanced fund from a pooled pension provider involves a similar process.

3.12 These two approaches are compatible with various management arrangements. Precise figures on the extent of specialist management vary, since definitions are not precise and the sample size varies, but Figure 3.1 gives some idea of the current distribution of funds.

**Figure 3.1: Manager structures by benchmark 1999**



Source: The WM Company

## Defined benefit schemes: methods of management

3.13 The investments of a self-administered defined benefit fund will be managed in one of three ways:

- as a segregated fund with in-house management;
- as a segregated fund with outsourced management; or
- using a pooled fund arrangement.

3.14 Segregated funds with in-house management take all investment decisions themselves.

3.15 Segregated funds with outsourced management can use either a peer group total fund benchmark or a customised total fund benchmark. The peer group benchmark approach results in what is traditionally known as a 'balanced mandate' or 'multi-asset mandate' for fund managers.

3.16 Similarly, pension funds employing pooled funds can use either type of benchmark. If they wish to adopt a peer group approach and delegate the strategic asset allocation to the fund manager or other pensions provider, they invest the pension fund assets in what is usually known as the pension fund provider's 'managed fund'. This is a general fund in which the provider sets the asset allocation, normally by reference to a peer group. If they wish to retain the asset allocation decision themselves, they would do this by selecting from a range of specialist funds for specific asset classes offered by their pension provider rather than investing in a single managed fund.

## Defined contribution schemes: investment decision-making

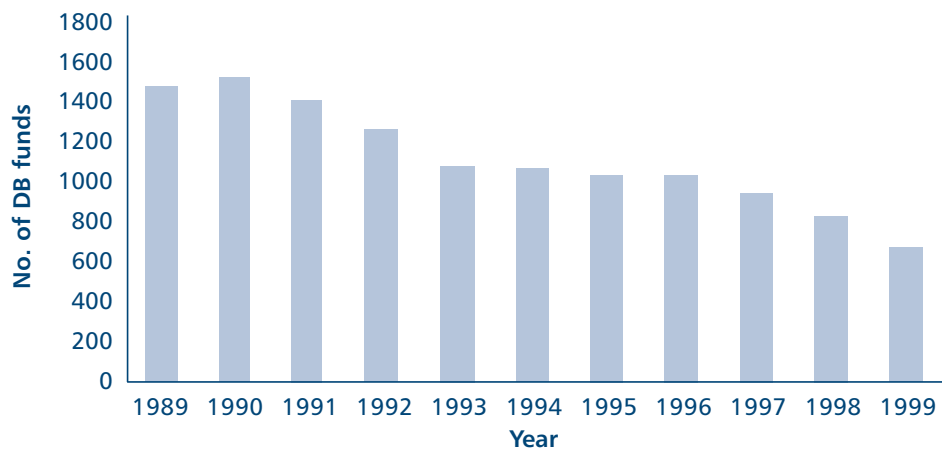
3.17 For defined contribution plans, the locus of decision-making depends on the nature of the scheme.

- 3.18 Defined contribution schemes offer one or more funds, normally with a default option. Where individual members select their own funds from a large number of different funds, it is fair to say that individual scheme members take strategic asset allocation decisions. But this happens in only a minority of cases. As set out in Chapter 6, most members of defined contribution schemes have either no investment choice or, where such choices exist, elect not to make allocation decisions, preferring instead to opt for the default option or a lifestyle approach.
- 3.19 In other words, for most of the assets in defined contribution schemes, decisions are taken in practice either by the trustees or by the pensions provider.

## Historic trends in methods of investment management

- 3.20 Figure 3.2 sets out a key change in the location of asset allocation decision-making for defined benefit schemes. The use of peer group benchmarked balanced funds has declined, leading to the increasing removal of the asset allocation decision from fund managers.

**Figure 3.2: The decline in peer group benchmarking since 1989**



Source: The WM Company

- 3.21 This resulted from a combination of factors:
- the Pensions Act 1995 (particularly the Minimum Funding Requirement which, whatever its faults, had a powerful effect in focusing trustees on the specific characteristics of their schemes);
  - growing dissatisfaction with the investment performance of a number of leading balanced managers;<sup>3</sup>
  - analysis by investment consultants cast doubt on the ability of fund managers consistently to add value in asset allocation; and
  - within the field of stock selection, it was questioned whether a single fund manager could be expected to have market-beating expertise in all markets.
- 3.22 An increasing number of funds concluded, therefore, that they should set their own asset allocation strategies and employ more specialist managers.

<sup>3</sup> Including Gartmore.



# Implications of investment management models

## Impact of benchmarks

3.23 One of the central theses of the review concerns the importance of the benchmark in driving fund manager behaviour, whether it is a peer group or an index benchmark. The consultation document sought views on the proposition that fund managers have an incentive to stick closely to their benchmark, since underperformance is much more likely to lead to mandate termination than outperformance is to winning a new mandate, and the risks are asymmetric. Moreover, this asymmetry grows in line with the degree of underperformance. The review's work has repeatedly confirmed this.

## Incentives created by peer group total fund benchmark

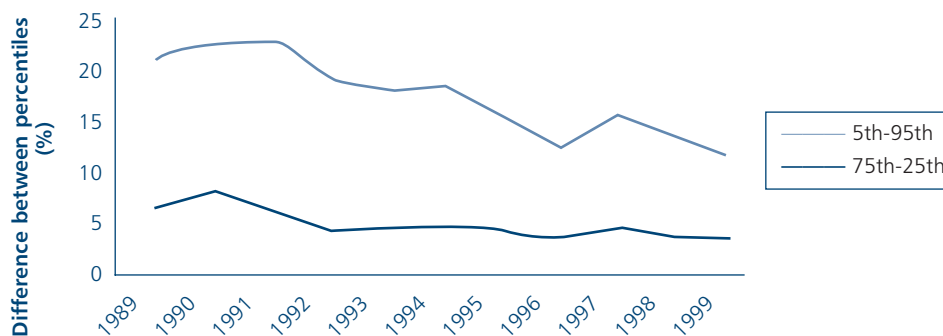
3.24 This implies that where a pension fund is using a peer group benchmark, the peer group will heavily influence asset allocation. Since each individual within the peer group is itself using the peer group, asset allocation is driven by *historic consensus* – whatever the current asset allocation. This means that the normal movement of capital in response to changing investment opinions operates more slowly but also with a greater degree of uniformity than it could otherwise:

- *more slowly*: a fund manager who is pessimistic about a particular market may still go underweight relative to the median fund or average allocation, but the business risk of diverging from the benchmark will limit willingness so to do;
- *with greater uniformity*: if enough fund managers share this manager's view and also go underweight in that particular asset class, the median and average allocation shift. This prompts even those funds remaining optimistic about the asset class concerned to reduce their investment in that market, in order to retain their position relative to the median or average.

3.25 Figures 3.3, 3.4 and 3.5 below show how use of the peer group has driven convergence. They are based on a ranking of peer group benchmarked pension funds by the size of their allocation to a particular asset class. The two lines represent the difference in the allocation of, respectively:

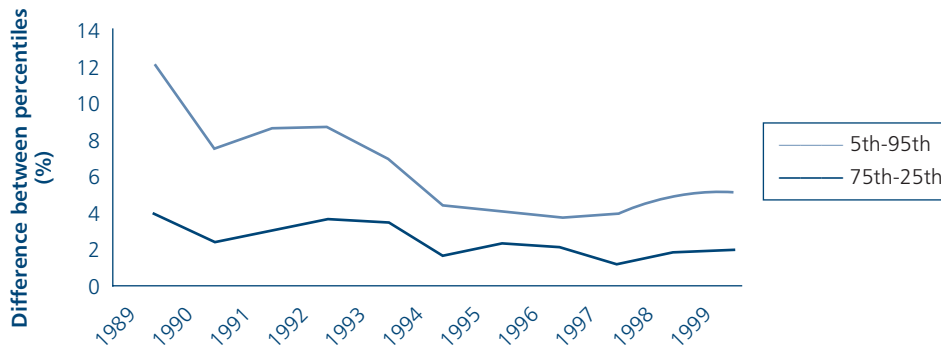
- funds in the 5th and 95th percentiles; and
- funds in the 25th and 75th percentiles.

**Figure 3.3: Convergence between percentiles over time: asset allocation to UK equities**



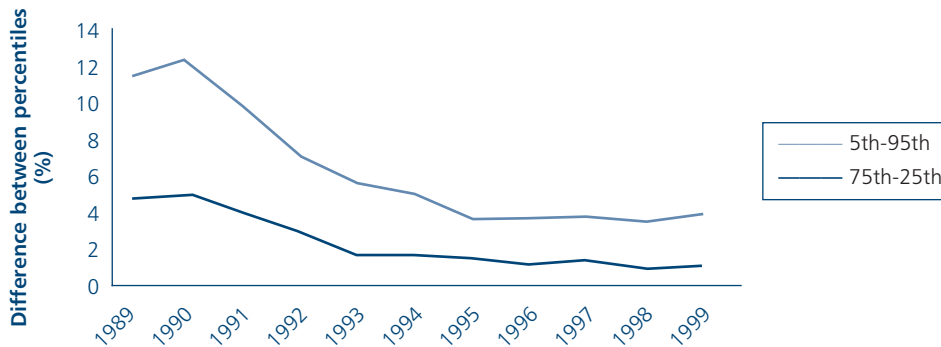
Source: The WM Company.

**Figure 3.4: Convergence between percentiles over time:  
asset allocation to European equities ex-UK**



Source: The WM Company.

**Figure 3.5: Convergence between percentiles over time:  
asset allocation to property**



Source: The WM Company.

- 3.26 These figures show a general decline in the differences between deciles, with the long-term trend moving towards the median result. This supports the view held by a clear majority of respondents: that peer group benchmarks create powerful herding incentives for asset allocation.<sup>4</sup>
- 3.27 This is not a new observation, but its implications have perhaps not been sufficiently spelt out to date. An investment strategy based on the median or the average pension fund does not relate to a pension fund's true objective: to meet its liabilities. Not only is this far from optimal investment behaviour; it is also potentially damaging to the interests of beneficiaries.
- 3.28 One argument put to the review was that during the 1980s, the peer group approach was appropriate because defined benefit pension funds were immature and therefore shared similar liability profiles. However, analysis undertaken by the review suggested that even in the mid-1980s, there was very little uniformity in the ratio of active to pensioner members across major schemes.<sup>5</sup> This argument is therefore not persuasive.
- 3.29 Given these observations, it is a matter of concern that significant sums are still being managed according to peer group benchmarks. The review believes that this way of managing pension funds has no satisfactory justification.

<sup>4</sup> This does not apply so strongly to security selection, as peer group data do not usually tell managers how peers are investing at the level of individual securities, although the index is increasingly relevant at this level.

<sup>5</sup> A random selection of major pension funds in 1985 showed ratios of active members to pensioners ranging from over 4:1 to less than 1:1, with a wide range of figures in between.

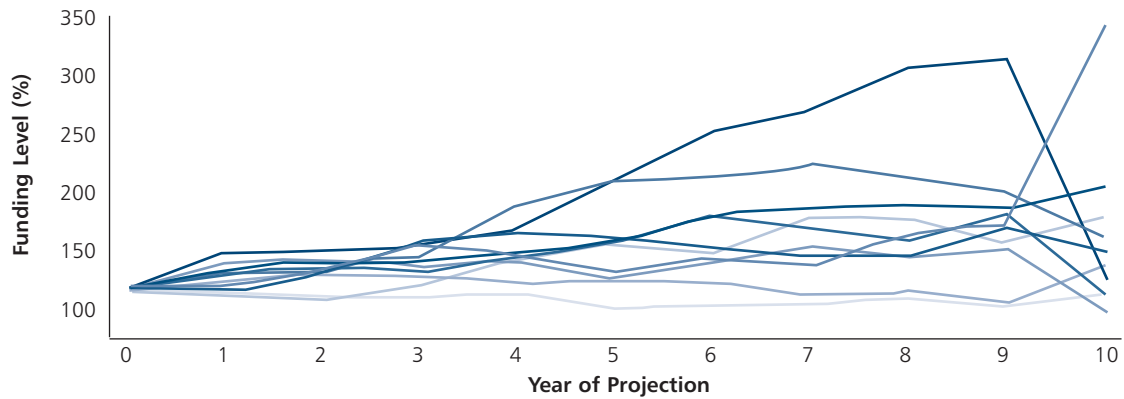
## **Implications of customised total fund benchmark**

- 3.30 Under this form of management the strategic asset allocation decision is taken elsewhere: at the level of the pension fund and therefore by its trustees. The precise decision taken by trustees can vary according to the type of asset allocation undertaken. It may involve no more than a broad split between equities and bonds, leaving the remaining division into different equity markets and bond markets to the manager. But increasingly the trend is to give fund managers a mandate to invest only in specific markets. The use of customised benchmarks (in practice, predominantly based on indices) has important incentive effects on security selection which are covered in Chapter 5, on fund management. The implications for asset allocation are considered here.
- 3.31 As set out in Chapter 2, pension fund trustees are not necessarily investment experts and are limited in the amount of time they can devote to their investment duties. In most cases they are not able – or even allowed in law – to take the asset allocation decision alone and unaided. Investment consultants, often actuaries, therefore play a central role: advising the trustees. Respondents said:
- ‘trustees are not generally experienced in investment, nor would we expect them to be...the trustees do not need to be experts themselves in the field of investment.’*
- ‘the reliance on professional advice...is entirely logical in an environment where trustees may be heavily penalised.’*
- ‘it would be surprising and disturbing if trustees did not seek and take professional advice on these important areas.’*
- 3.32 However, it is worth emphasising that the relationship between an investment consultant or actuary and his or her pension fund client is, with a few exceptions, entirely different from that between the pension fund and the fund manager. The fund manager makes decisions. The investment consultant does not. Investment consultants provide advice; it is the trustees who make the decision.
- 3.33 The key technique used by investment consultants (and consulting actuaries) in advising their clients is the asset-liability model. This deserves further attention.

## **Asset-liability modelling**

- 3.34 Asset-liability modelling is a financial risk assessment and asset planning tool. It is widely used by pension funds and insurance companies to help set long-term asset allocation strategies appropriate to the risk tolerance and liabilities of the institution. The technique forms an extension to the normal actuarial valuation process for pension funds. The parameters in a normal valuation, which are assumed to be fixed, are allowed to fluctuate in a controlled manner about their long-term assumed values. In other words, asset-liability modelling turns a deterministic method of valuation into a stochastic process, as in this graph (figure 3.6), which demonstrates possible funding levels under ten different simulated scenarios:

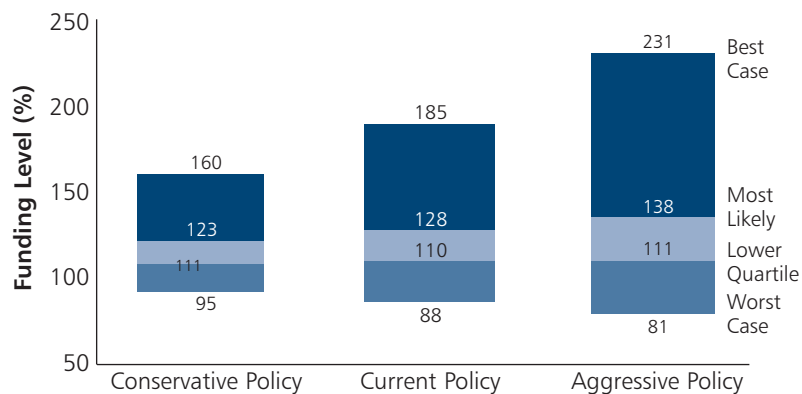
**Figure 3.6: Projection of funding level for 10 simulations**



Source: Illustrative only, with thanks to Watson Wyatt.

3.35 This stochastic approach enables the adviser to project varying courses of inflation, asset returns and related factors into the future, thus creating a range of valuation results and financial statistics for the fund from which inferences can be drawn. By running thousands of such simulations, tables such as those below (figure 3.7) can be constructed which show the implications of various policies for funding levels.

**Figure 3.7: Funding levels in 10 years**



Source: Illustrative only, with thanks to Watson Wyatt.

3.36 Quantitative analysis is an essential tool of professional investment decision-making. But there are important caveats.

3.37 Any such modelling process depends heavily on the assumptions made for it. The review has already discussed the way in which the definition of asset classes requires judgement. Different taxonomies of asset classes create very different models. Moreover, asset-liability models make extensive use of long historic time series. Given the important structural changes that have taken place in financial markets over the past thirty years (privatisations, substantial deregulation, major shifts in ownership of financial assets, two major supply shocks and so on) historical correlations can be of only limited use.

3.38 A number of respondents also pointed out that heavy reliance on quantitative modelling creates an inherent bias in favour of asset classes with long time series. Those without a long time series cannot be modelled and so risk being ignored.<sup>6</sup> It is worth pointing out that if,

<sup>6</sup> This is a powerful explanatory factor for the historic reluctance of UK pension funds to invest in private equity – over and above the extent explicable by the particular features of the asset class. The decision to invest in private equity is unlikely to emerge from a process of quantitative modelling, as the data simply does not exist to permit it.

as many investors believe, poorly-researched markets with limited data are likely to offer the best opportunities for higher risk-adjusted returns, it is precisely those asset classes that are not susceptible to quantitative modelling which may be most worth pursuing.

- 3.39 Qualitative judgements of various kinds therefore play a crucial part in shaping the output of such models. Yet research suggests that among schemes using an asset-liability model, trustees were involved in the setting of underlying assumptions in only 30 per cent of cases.<sup>7</sup> This is partly to be expected in the light of the findings on trustees' levels of investment expertise.
- 3.40 In most cases, consultants are currently the sole source of serious qualitative input. They therefore have a significant impact on investment decisions in practice – yet in law they are not taking the decisions and, indeed, are not permitted to take them. The review believes that this divergence between reality and theory is unhealthy.

## Impact of advice on trustees

- 3.41 Putting to one side concerns about the nature of the advice given to trustees, there is the separate question of whether it is desirable that trustees should make asset allocation decisions, despite their frequently low level of investment expertise. As set out above, respondents argued that trustees did not need to possess investment expertise, as they were able to take advice. An analogy used in discussion was that of company directors taking legal advice when the company faced a legal issue. No one would suggest that company directors had to be lawyers.
- 3.42 The review does not believe that this is the correct analogy. Given that the purpose of a trust is to hold assets in safekeeping, investing the assets is one of trustees' most central responsibilities – not the only one, but a very important one. For most companies, legal issues do not assume this importance or arise with this regularity. A better analogy would be scientific issues for a pharmaceutical company: by no means the only important decisions which the company takes, but crucial and frequent. One would not expect to find a board of directors of a pharmaceutical company arguing that as they took advice from a firm of expert scientific consultants, it did not matter that board members themselves had no scientific qualifications and no experience of research and development. They would certainly take advice, and some directors would lack research and development experience, but collectively the board would have the experience and skill to mount a sophisticated challenge to the advice received.
- 3.43 It is hard to argue that under present arrangements, trustees are able to challenge complex asset-liability models and their underlying qualitative judgements, when a majority have no investment qualifications and received less than two days' training when they started as trustees.
- 3.44 Analysis from the survey of trustees tends to confirm this view. It is true that 52 per cent of trustees said they always questioned their consultant's advice, and 77 per cent felt they exerted significant influence on strategic asset allocation. But 78 per cent of trustees surveyed also said they followed the advice of their investment consultants, and 63 per cent agreed that their fund 'sticks as closely as possible to the accepted practice in the industry'.

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<sup>7</sup> Phillips and Drew, *Investment Directions*, 2000, p.2.

## Customised benchmark approach: conclusion

- 3.45 The customised benchmark approach creates a process in which asset allocation is powerfully driven by a form of modelling that pension fund trustees only partly control or understand. The result is to place significant influence – if not actual decision-making power – in the hands of the investment consultant. Yet in law, investment consultants are not responsible for the decisions – indeed they may not be, as this would require a different sort of authorisation under the Financial Services Authority.
- 3.46 This in itself is a problem. A situation where one party has legal responsibility for taking a decision but, lacking much of the necessary information and expertise, relies so heavily on a second party, is not conducive to good decision-making.
- 3.47 There are two further related concerns about the asset allocation process.

## Resources devoted to asset allocation in customised benchmark model

- 3.48 Fund management is a large, profitable industry, paid through an *ad valorem* fee, and its employees are well-paid. By contrast, a pension fund will usually pay many times less for asset allocation advice than for fund management (perhaps only 5 per cent as much, according to one respondent to the review).
- 3.49 Yet a series of academic studies suggest that asset allocation may explain most of the variations in pension fund returns. For example:
- 'investment policy dominates investment strategy (market timing and security selection), explaining on average 93.6% of the variation in total (pension) plan return.'*<sup>8</sup>
- 3.50 Whatever the *precise* relative contributions to performance of asset allocation and stock selection – which is a matter of controversy – the review is concerned that institutional investors may be devoting insufficient resources to a service which, on the basis of a respectable quantity of academic research, may contribute the majority of their investment performance.
- 3.51 Of course, it does not automatically follow that the price of a process input should reflect its value – far from it. But there are grounds to believe that pension funds would improve investment decision-making if they were willing to spend more on asset allocation and quite possibly less on security selection:
- as set out in Chapter 4, by keeping profitability low, the low level of resources committed to asset allocation advice appears to be one of the factors driving the concentration of the investment consulting industry. Higher fees could attract a greater and more diverse range of firms into the market;
  - the present level of in-house investment expertise of most pension funds is so modest that spending relatively small sums of money on hiring an in-house specialist or recruiting professional trustees would almost certainly yield benefits.

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<sup>8</sup> G. Brinson, L. Randolph Hood, and G.P. Beebower, 'Determinants of Portfolio Performance', *Financial Analysts Journal*, July/August 1986.

- 3.52 It is true that over the last ten years institutions have increasingly questioned whether the fees of active stock selection are justified by superior investment performance (see Chapter 5). But they have yet to question seriously whether it would be worth devoting *more* resources to asset allocation.

## Performance measurement of asset allocation

- 3.53 Pension funds are not necessarily refraining from paying more for asset allocation advice because they are unaware of academic research. They are also heavily influenced by the fact that they have no formal means of judging the success of asset allocation decisions, much less the extent to which an investment consultant has contributed to the investment return of the fund. The quality of asset allocation advice is not routinely or systematically monitored or assessed.
- 3.54 This is regrettable. Effective assessment of asset allocation advice, while not automatically leading to a greater level of attention and resources being paid to asset allocation, would encourage it by highlighting the value that can be added or lost through these decisions.

## Conclusions and recommendations

- 3.55 The peer group benchmark approach leads to a distorted system of asset allocation under which a historic industry consensus is the main driver of industry decisions. Such a system serves the interests of beneficiaries poorly.
- 3.56 The customised benchmark approach relies on asset allocation being carried out in a system with limited resources and suboptimal systems of performance measurement. As many of the ultimate customers (that is, trustees) lack expertise to interpret critically the issues and difficulties inherent in the advice they are given, they have little choice but to follow it. Yet they – and not those providing the advice – retain full legal responsibility for their decisions.
- 3.57 The review believes that this situation reflects a lack of clarity and transparency about the way pension funds' investments are managed. This situation would be improved if trustees had explicitly to consider and set out their thinking on such issues as:
- what the investment objective of the fund was;
  - how it related to the objectives set to fund managers; and
  - whether those taking a decision were in fact best placed to do so.
- 3.58 This would have two effects. On the one hand, it would make it more difficult to continue with the present arrangements. It should be clearer, for example, that the investment objective of a defined benefit pension fund should logically be expressed in terms of the future growth of the liabilities of that particular fund. It would be more difficult to defend a decision to implement such an objective by giving a mandate to investment managers that was based on a wholly different and unrelated objective: namely to outperform other pension funds. On the other hand, it would also enable much greater diversity of remits to fund managers, within the general requirement that they should be consistent with the overall objective. Such diversity would be desirable and helpful, as remits could be tailored to the requirements of each individual pension fund, instead of to conformity with the peer group.

The review therefore recommends that trustees should:

- **set out explicitly an overall investment objective for the fund which represents their best judgement of what is necessary to meet the fund's liabilities;**
- **set objectives for their fund managers that are coherent with the fund's aggregate investment objective; and**
- **set out explicitly what decision is being taken by whom. Decisions on the investment of the fund should be taken only by those with the skills, information and resources necessary to take them effectively.**

3.59 The review believes that adoption by pension funds of these recommendations would challenge effectively many of the suboptimal practices outlined above. The issue of a greater stress on the significance of asset allocation is an important and necessary change which is considered in the following chapter.



## CHAPTER 4:

# Actuaries and Investment Consultants

## Introduction

- 4.1 Chapter 3 has made clear the importance of the role played by investment consulting advice. The review's consultation document also raised the specific issue of whether concentration in the investment consulting industry raised competition concerns.
- 4.2 This chapter focuses the analysis specifically on the investment consulting business, first to establish whether there are competition concerns, and second, to understand how the nature and structure of the industry affect investment decision-making.
- 4.3 The chapter:
- sets out the current state of the industry;
  - examines the specific practice of linking or 'bundling' actuarial and investment consulting advice;
  - assesses various possible explanations of the high level of concentration in investment consulting;
  - looks at wider policy issues raised by the analysis; and
  - makes recommendations about the terms on which pension funds should use investment consulting advice.

## Industry background

### *Actuarial advice*

- 4.4 The Pensions Act 1995 sets out the manner in which trustees should interact with their advisers. In particular, it requires trustees to engage suitably qualified and experienced persons, and to lay down the terms of engagement in writing.
- 4.5 The Pensions Act 1995, supplemented by Guidance Notes issued by the Faculty and Institute of Actuaries, also governs appointed Scheme Actuaries and other actuaries giving advice to pension funds.<sup>1</sup>

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<sup>1</sup> 'Guidance notes for actuaries advising the trustees or a participating employer' (GN29). The notes say that the appointed actuary must have 'appropriate knowledge and practical experience of that category of scheme' and that the Scheme Actuary Certificate must be current. Appointment as a Scheme Actuary is 'personal and not the appointment of the firm for which the actuary works'. The Scheme Actuary must 'obtain from the Trustees a signed Undertaking agreeing to advise the Scheme Actuary of such events as the Scheme Actuary specifies.' A list of such events is appended to the guidance note. In drawing up an undertaking the Scheme Actuary "must be satisfied that the Trustees understand what the Scheme Actuary would consider to be 'material', 'unexpected', 'major' etc." (The actuary may have to report some events to the Occupational Pensions Regulatory Authority.)

## **Investment Advice**

- 4.6 Investment consultancy began to emerge as a business only in the early 1980s and there are still funds that make little or no use of investment consultants. Driving the new demand for investment consultancy were factors such as the growing awareness of differences in returns across asset classes and across investment managers, and a desire, led by trustees of larger funds, for greater professionalism in their approach.
- 4.7 Over time, additional forces have come into play. These include a sharper focus on funding levels, particularly with the introduction of the Minimum Funding Requirement (MFR); greater consciousness of the risk and potential rewards of departing from asset-liability matching; and differences in the relative performance of balanced managers, specialist active managers and index managers.
- 4.8 As a result, trustees began to look for help in two main areas:
- strategic asset allocation. Trustees became increasingly aware that it is difficult to match assets precisely with liabilities, and that while a reasonably close match of asset classes with liability classes can reduce the volatility of funding levels, it can also reduce a fund's long-term return. It became clear that any trade-off between the two aims of matching liabilities and generating good investment returns was a complex matter, which funds felt ill-equipped to tackle; and
  - investment manager selection. A growing body of evidence pointed to the different levels of return that fund managers were delivering on the assets entrusted to them; choosing a manager was therefore an important decision.
- 4.9 Both these aspects can be analysed quantitatively. Modelling the first is closely related to the core business of actuaries. As actuaries were already advising pension funds, their clients naturally turned to them for advice on these additional matters.
- 4.10 These two types of advice, in reality quite different and requiring rather different skills, were combined into a business known as 'investment consultancy', in which almost all the major actuarial firms began to develop capabilities.

## **The market for investment consulting**

- 4.11 The UK investment consulting market is estimated to be worth around £80 million a year<sup>2</sup> in fees. This compares with an estimated market size for actuarial services of roughly £250 million<sup>3</sup> and an estimated £4.9 billion for institutional fund management.<sup>4</sup> The main investment consultancies in the UK include:
- Watson Wyatt;
  - William Mercer;
  - Bacon & Woodrow<sup>5</sup>; and
  - Hymans Robertson.
- 4.12 These firms currently provide investment consultancy in at least 70 per cent of investment reviews for funds with assets of over £25 million.

<sup>2</sup> Based on scaling up information from key industry participants. This figure was supported in interviews with participants.

<sup>3</sup> Informal estimates by Charles River Associates.

<sup>4</sup> Estimated by PricewaterhouseCoopers.

<sup>5</sup> The investment consulting business of Bacon & Woodrow is currently merging with Hewitt Associates, a US management consulting firm.

- 4.13 It is hard to arrive at definitive market share figures, because of the varying roles and coverage of firm activities. However, an analysis of a sample of manager selection mandates over a nine-month period in 2000 found that William Mercer handled roughly 26 per cent of such mandates, Watson Wyatt 23 per cent, Bacon & Woodrow 22 per cent and Hymans Robertson 14 per cent – a total of 85 per cent for the four firms.<sup>6</sup>
- 4.14 Table 4.1 presents roughly comparable market share data from another source. Concentration in the industry is greatest for the largest pension funds (over £1 billion). It appears that only a few providers can service these funds. Information on concentration is, however, based on the number of clients rather than on the value of funds for which firms provided advice. The relatively small number of funds and the large range of fund sizes in this group may make these market share figures less reliable than for other size ranges.
- 4.15 The top four providers hold at least 70 per cent of the market in investment consulting. The Herfindahl-Hirschman Index<sup>7</sup> for the industry is around 1800. As a point of comparison, US anti-trust authorities regard a Herfindahl-Hirschman index of anything over 1000 as a matter of possible concern.

**Table 4.1: Market shares for pension advisers, by size of pension scheme (%) 1999**

Adviser	Size of Fund						
	£1 billion plus	£250m – £999m	£150m – £249m	£75m – £149m	£25m – £74m	£10m – £24m	< than £10m
Watson Wyatt	43.3	29.0	21.9	21.2	15.6	13.0	3.8
William Mercer	15.8	23.9	24.8	32.4	27.7	28.5	34.6
Bacon & Woodrow	16.7	15.4	19.0	17.3	12.4	10.6	3.8
Hymans Robertson	9.2	9.7	6.7	2.8	1.5	2.4	0.0
“Big Four”	85.0	78.0	72.4	73.7	57.2	54.5	42.2
Aon	4.2	5.8	4.8	7.3	10.6	9.2	8.7
Lane Clark & Peacock	1.7	3.1	4.8	4.5	2.1	1.9	1.0
Towers Perrin	0.0	1.9	6.7	3.4	2.1	2.4	0.0
KPMG	0.0	0.0	0.0	0.6	0.9	1.9	1.0
PwC	0.0	0.4	0.0	0.6	0.9	1.9	1.9
Subtotal	90.8	89.2	88.6	89.9	73.7	72.0	54.8
Other <sup>8</sup>	9.2	10.8	11.4	10.1	26.3	28.0	45.2
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
<b>HHI</b>	<b>2509</b>	<b>1790</b>	<b>1592</b>	<b>1892</b>	<b>1289</b>	<b>1200</b>	<b>1307</b>

Source: Datamonitor analysis of ‘Pension funds and their advisers’, AP Information Services; Charles River Associates calculations.

- 4.16 The investment consulting industry appears to have low levels of both customer switching and targeted solicitation. Authoritative data on solicitation levels are not available, particularly since definitions of ‘solicitation’ vary. Industry estimates suggest that perhaps 50 per cent of funds receive a targeted solicitation in any given year. This is low compared to many professional service markets. Moreover, the review was told that actual switching between providers by pension funds is infrequent: many funds retain the same firm for 20 years or more.

<sup>6</sup> Based on mandates published on ii-q.com website, 18th October 2000, covering the period from 1 January to 18 October 2000.

<sup>7</sup> The Herfindahl-Hirschman index provides a relative measure of market concentration, and is calculated as the sum of the squares of each individual company’s market share.

<sup>8</sup> Smaller size pension funds in particular use insurers to provide a full range of advisory and management services.

## **Bundling**

- 4.17 One of the features of the investment consulting market is the frequency with which pension funds employ as investment consultants the same company that provides actuarial advice. Such ‘bundling’ of goods can be evidence of an uncompetitive market. The analysis therefore considers this issue first.
- 4.18 For the bundling of actuarial and investment consulting services to have anti-competitive effects, a number of conditions would have to be fulfilled. There would need to be a position of market power in one market (the market for the ‘tying’ good), which could then be leveraged into another market that would otherwise be competitive (the market for the ‘tied’ good).<sup>9</sup> An offending firm (or firms) would also be expected to have increased prices or reduced quality in the tied services market, in order to increase profits above those that would normally be observed in a competitive market. The symptoms and conditions necessary for a competition problem would therefore comprise:
- a position of market power in the tying market (in this case, the market for actuarial services);
  - a compulsory mechanism linking the tying service to the tied service (here, investment consulting services); and
  - a situation of sustained profitability in excess of a reasonable rate of return.
- 4.19 Not all of these symptoms are easy to observe. However, it is not necessary to cover all of them, as the tying mechanism itself should be easily observable. Tying can take a variety of forms, but the most likely would be:
- contractual arrangements specifically requiring the purchase of both services from the same firm; or
  - pricing arrangements with a similar net effect.
- 4.20 The assessment of supernormal profit is notoriously difficult. Data on profits are not publicly available where market participants are private partnerships, as is the case for several of the firms involved here. Where data are available, significant measurement issues arise, for example because accounting profits are not necessarily a good measure of economic profits, and because it is difficult to attribute profits reliably between the different businesses of multi-line firms.
- 4.21 Furthermore, even if ‘excess’ profits were identified, it is not clear whether they would indicate lack of competition, or merely reflect the success of firms that have reached a position of dominance through superior performance. Given these difficulties, profits are not easily used as an indicator of competition in the market (although they will feature in a later part of the analysis). Nonetheless, some imperfect proxies – the level of prices and service quality – can provide a useful litmus test of whether significant competition problems exist.
- 4.22 The review has not been able to identify any evidence of explicit tying in the provision of actuarial and investment consulting services. The review is not aware of any policies requiring customers of the integrated investment consulting and actuarial firms to purchase both services from them. While they generally *try* to sell both services, this does not preclude customers from separating them. Two of the largest investment consulting providers told

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<sup>9</sup> If this is not the case, bundling will not succeed in raising prices, as the bundle of services can be purchased at competitive rates by buying the components separately.

the review that they had large customers who had chosen to separate the services, and interviews with pension funds confirmed that this was happening.

- 4.23 Investment consulting firms that also supply actuarial services generally argue that providing both services together produces certain practical advantages. For example, they argue that the actuary and investment consultant need to share a significant amount of information, which is generally easier within an established team. To the extent that this requires fewer resources, it should translate into a cost advantage of supplying the two services together, as consulting services are billed on a time and materials basis.
- 4.24. However, the fact that some funds choose not to source the two services from the same firm suggests that the cost advantage of doing so cannot be major. Indeed, a number of industry participants have argued that from a statement of the liabilities it is perfectly simple to undertake a full study of the assets without suffering any loss of synergy. Moreover, not all investment consultancy services in the UK also provide actuarial services. Research suggests that around 20 per cent of pension funds use different firms to provide actuarial and investment consulting services.<sup>10</sup>
- 4.25. The review is therefore not persuaded that the bundling of these services is in itself anti-competitive.

### ***High concentration and low switching levels: discounted factors***

- 4.26 The review examined a number of factors that do not alone appear to explain the concentration of the industry:
- brands;
  - access to skilled labour;
  - regulatory issues; and
  - customer switching costs.

### ***Brands***

- 4.27 Investment consultancies in the UK derive their brand strength largely from their actuarial history. They have often advised trustees on funds' liability profiles for a long period of time, and actuarial consulting relationships can become very long term (20 to 25 years is the most common period of employment<sup>11</sup>). Advertising to develop brand loyalty is not particularly strong in this market, as brands are built over time. The small number of consulting firms, and the niche market in which they operate, mean that firms contact potential clients directly, rather than through expensive mass media marketing. Making the initial contact is therefore potentially cheap, as information on the identity and assets of pension funds is easily accessible.<sup>12</sup> However, the process of building a credible brand with a track record acceptable to major funds would undoubtedly represent a significant cost in time and money to an unbranded entrant.
- 4.28 The importance of brand suggests that entry would come by one of two methods. Either an entrant could import a competitive brand from another market (perhaps from abroad); or they could build the business slowly over time.

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<sup>10</sup> Greenwich Associates, 2000.

<sup>11</sup> 1999 and 2000 *Company Pension Fund Surveys*, The Pension Fund Partnership and MRM Projects Ltd.

<sup>12</sup> See, for example, *Pension Funds and their Advisers 2000*.

4.29 There is no reason why entry of a strong brand from offshore or other markets should be particularly difficult, given adequate economic incentives, if incumbents are performing sufficiently poorly to be easily displaced. Indeed, this is already evident, with the entry of two major accounting firms active in the market (KPMG and PwC); and Frank Russell, SEI and Stamford Associates from the US. While these firms have not gained leading shares of the investment consulting market, it is unlikely that this is due to any lack of credible brand.

### ***Availability of skilled staff***

4.30 Investment consulting is a professional services market based on people, who are a potentially mobile input. Potential entrants might be able to acquire market share through groups of practitioners breaking away from established competitors, perhaps bringing with them the added benefit of a portion of the client base. While the review is not aware that this has happened to date on any significant scale in investment consulting, it does occur in other professional services and businesses active in financial markets. There seems no reason why it should not happen in investment consulting, given the right incentives.

4.31 As a result of the recent growth in both the UK and world economy, and the growth in demand for investment consultancy services, these services are currently experiencing a more general shortage of skills. Investment consulting firms reported difficulty in recruiting and retaining skilled staff, especially as they compete directly with the fund management industry for personnel. However, this in itself does not explain concentration. If there is demand for investment consulting services, the question is why that demand does not lead to price increases, which in turn would permit higher salaries and the entry of additional qualified staff. This is considered later.

### ***Regulatory barriers***

4.32 There are regulatory barriers (in the broad sense) for both actuaries and investment consultants. Only qualified members of the Faculty and Institute of Actuaries may undertake the role of Scheme Actuary, while giving investment advice is regulated by the Financial Services Authority (FSA) and requires authorisation. However, neither of these barriers is likely to be significant enough to explain the current degree of concentration or the rarity of switching.

### ***Customer switching***

4.33 The review did not identify any specific explicit customer switching costs that might be considered a serious barrier to entry in the investment consulting market. Trustees are able to ask for tenders or hold 'beauty parades' for investment consultants, at minimal financial cost. The main cost of switching is the time and psychological cost of re-establishing relationships between the client and consultants, and the inevitable cost to the new consultant of learning the new client's business.

4.34 But time costs and psychological costs are normal business issues that are common to any professional services market. While a new entrant will almost inevitably need to offer a superior service to the incumbent to win business from a client, this is a normal competitive issue for any business, and not an uncompetitive barrier to entry.

## **High concentration and low switching: more significant factors**

4.35 The review has identified two factors which it believes offer more convincing explanations for the high concentration and low switching in the industry:

- the research function requiring a large minimum efficient scale of operation; and
- apparently low margins and small size.

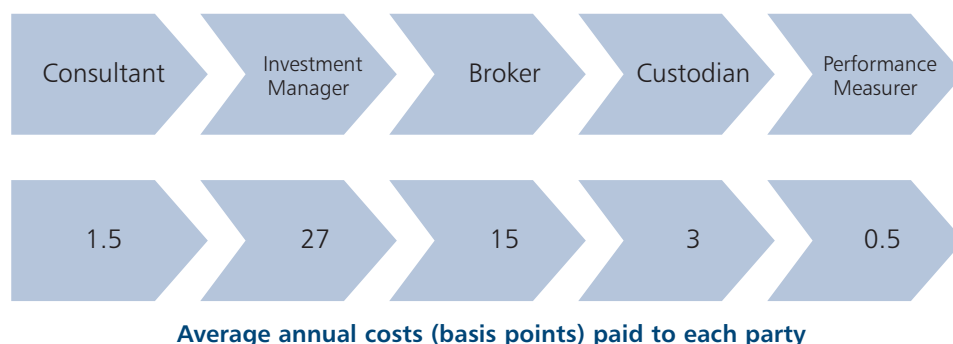
## Research and minimum scale

- 4.36 A number of industry participants argued that the need for research created a minimum efficient scale for an investment consulting business and therefore constituted a barrier to entry. This is certainly encouraged by the trend away from balanced manager mandates towards specialist mandates. For balanced mandates, an investment consultancy needs to research intensively perhaps no more than ten balanced managers. But in a world of specialist mandates, there are multiple asset class product offerings – UK, European, US, Japanese and emerging markets equities, UK fixed interest, international fixed interest and index-linked and so on – all of which require research. In other words, to cover a similar number of managers in each specialist class requires a substantial increase in research resource. The burden increases considerably when the alternative more complex asset classes of private equity, property and hedge funds are added.
- 4.37 It is true that the nature of investment consulting means that personal service exerts a major influence on trustees and pension managers. Smaller firms tend to put more emphasis on this than larger ones. This helps to explain why smaller investment consultancies can continue to win work. But the issues posed by the economics of research remain significant in driving concentration.

## Low margins and small size

- 4.38 As indicated already, it is extremely difficult to assess the level of excess profits accurately in any industry, particularly a service industry dominated by partnerships. However, a number of facts suggest that profitability in investment consulting is, indeed, low:
- the review was told on a number of occasions that margins are poor in investment consulting;
  - there is anecdotal evidence to the effect that in mergers and acquisitions transactions, investment consulting businesses have received low valuations;
  - fund managers are typically paid more than investment consultants. Pay is not the same as profitability, but given the investment consulting industry's known difficulties with staff recruitment, it supports a thesis of low margins. Otherwise one would expect investment consulting firms to have raised their salaries to compete more effectively with fund management; and
  - the picture of low profitability is also confirmed in Figure 4.1 below, which compares the proportion of the value chain captured at each of the main stages of the institutional investment process.

**Figure 4.1: Value added chain**



Source: Watson Wyatt Global Asset Study (figures based on a typical fund of £200m).

- 4.39 The impact of relatively low margins is visible in two main areas. First, the combination of low margins and high research costs means that only a small number of large firms are viable. Second, it makes entry by stand-alone investment consulting firms unlikely. It is still possible for firms diversified in other ways to solicit customers and seek to enter the market, as the large accounting firms have shown. However, low margins provide little incentive for them to do this if entering the market requires substantial investment in recruitment, developing a research base, marketing or other fixed expenses.
- 4.40 Low margins are at least partly driven by the business model used by investment consultants. Fund managers take on their clients' money to manage it on their behalf, taking investment decisions and therefore, within the mandates they have been given, ultimate responsibility for the funds' investment performance. Investment consultants advise; they do not take final responsibility for decision-making. Fees paid to decision-makers are, not surprisingly, higher than those paid to advisers.
- 4.41 Of course, in principle there is no reason why trustees could not look to a broader range of potential providers – especially for asset allocation advice – and pay higher fees if they delivered the added value that made this worthwhile. Indeed, the review believes they should be willing to do so. The main constraint at present probably relates to the broader issues surrounding trustees, and especially their dependence on their advisers, discussed in Chapter 3.

### **Conclusion on competition issues**

- 4.42 Low profitability, high research costs and a small market are the main reasons for high concentration in the investment consulting market. The review found no evidence of the classic competition problem of market power leading to monopoly profits.

### **Other policy concerns**

- 4.43 The state of the industry does, however, raise broader policy concerns.

### **General impact of industry structure**

- 4.44 The importance of investment consulting advice in the decision-making process calls ideally for a market characterised by a wide range of different firms with specialisms in particular areas, driven by high levels of entry into the industry and high levels of customer solicitation. Instead, the industry is best described as a small, low-profitability market in which a handful of long-established firms offer similar products and limited expertise in some important specialist areas, including private equity. Despite the best efforts of the firms involved, the result is likely to be a narrow range of advice with limited innovation. Respondents to the review commented that:

*'Concentration has led to... a commonality of investment policy among pension funds.'*

*'In our experience, the advice offered by investment consultants does not vary greatly from practice to practice.'*

*'Although concentration of the consulting industry and the undue influence of a small handful of individuals on the investment policy of the industry is undesirable, worse is the generic "one size fits all" advice which the consultants provide.'*



*'Concentration leads to greater conformity – and potentially the “last lemming over the cliff” syndrome. It would seem to be another symptom of a lack of confidence/knowledge among trustees.'*

- 4.45 Greater diversity among providers and competition over a broader range of factors would bring undoubted benefits.

### **Advice on alternative assets**

- 4.46 While such concerns apply even to conventional investment markets, they become more acute in relation to new and alternative asset classes. As identified above, the research burden on investment consulting businesses is considerable. Alternative asset classes add to this difficulty. The sources of advantage in private equity and in hedge fund investing are both more important (because the variance between the best and worst investors is much greater than in more efficient markets) and much more complex. Skill in asset-liability modelling and other statistical analysis, which depend on long time series, has only limited relevance. It has been difficult for firms to build up the required expertise in these areas given the resource constraints they face. Respondents to the review from the private equity and hedge fund communities referred to most of the major consultants only recently turning their attention to these asset classes. Respondents felt that investment was needed to develop the necessary level of understanding.

### **Quality of manager selection advice**

- 4.47 In discussion, a large number of fund managers expressed scepticism about the quality of investment consultants' manager research. One would expect this sort of criticism from managers who were unsuccessful in winning mandates – the 'sour grapes' effect. But it was equally evident among managers who are succeeding in the present climate.
- 4.48 The review finds it surprising, given the effort devoted to analysing the performance of fund managers, that investment consultants have undertaken so little statistical work to demonstrate their ability to add value through manager selection. The topic has been discussed, notably at recent meetings sponsored by the National Association of Pension Funds, but it has not resulted in concerted action. Measurement certainly entails some practical difficulties, but experience from the fund management industry suggests that once measurement becomes routine, it is possible to establish standards that allow comparison across an industry. There does not appear to be any reason why this should not apply equally to consultants' manager research activities.

## **Conclusions**

- 4.49 The investment consulting industry is characterised by high levels of concentration and low levels of customer switching. At the same time, profitability appears low.
- 4.50 The review has concluded that the low levels of profitability rule out conventional competition concerns. However, there are concerns from a wider perspective. The market structure identified by the report is likely to lead to the provision of advice that is relatively uniform, insufficiently specialised and in particular, poorly equipped currently to deal with alternative asset classes. There appears to be little assessment of the manager research activities of consultants.
- 4.51 The review believes that the solution to this problem lies principally with the industry's customers: pension funds.

The review recommends that:

- **contracts for actuarial services and investment advice should be opened to competition separately. Pension funds should be prepared to pay sufficient fees for each service to attract a broad range of kinds of potential provider;**
- **trustees should arrange for formal assessment of their advisers' performance and of any decision-making delegated to them;**
- **trustees should not take investment advice on an asset class from an investment consultant who lacks expertise in that asset class; and**
- **fees devoted to asset allocation should properly reflect the contribution it can make to the fund's investment performance.**

4.52 The investment approach described in Chapter 11 sets out a framework within which these recommendations can be implemented.

## CHAPTER 5:

# Fund Managers

### Introduction

- 5.1 Fund managers play a fundamental role in the investment decision-making process for institutional assets. Although the balanced mandate, under which the fund management company was effectively the main investment decision-maker, is in decline, it has not yet disappeared even among funds using segregated management, and the equivalent model remains important in pooled pensions.<sup>1</sup> Moreover, even where asset allocation decisions are taken by the institutional client – the pension fund – the managers still take the security selection decision, and are responsible for the day-to-day management of the portfolio.<sup>2</sup>
- 5.2 Competition is essential for innovation. The question of the level and nature of competition in fund management services is fundamental to understanding their role in investment decision-making. If managers do not face a realistic threat of being displaced by their competitors, they are unlikely to develop new or different investment strategies, or investigate new markets and products.
- 5.3 Determining the nature of competition is only part of the question, however. Fund managers are not, in this instance, investing on their own behalf. They act as agents for their institutional clients such as pension funds and insurance companies.<sup>3</sup> The objectives of principals and their agents need to be aligned through the correct understanding of client needs as well as incentives, including the fee structures and performance measurement techniques used by institutional clients and their advisers.
- 5.4 The analysis consists of:
- a description of the fund management industry;
  - analysis of the nature and strength of competition in the industry, looking at the buying process, the structure of fees, and ease of switching;
  - analysis of potential sources of investment distortion: the manager selection process, the incentives created by fees and performance measurement, the skills and capabilities of the industry; and
  - consideration of the specific issue of the willingness of fund managers and their clients to intervene in investee companies.

### The fund management industry

- 5.5 Fund managers perform a range of activities centred around the core service of investing client assets in order to generate superior returns for a given level of risk or the lowest level of risk to achieve a targeted return. In doing so they play a crucial role in the competitive pricing of capital. Fund management organisations can be roughly divided into two groups:

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<sup>1</sup> Balanced mandates are still used extensively by local authority funds – see Appendix B.

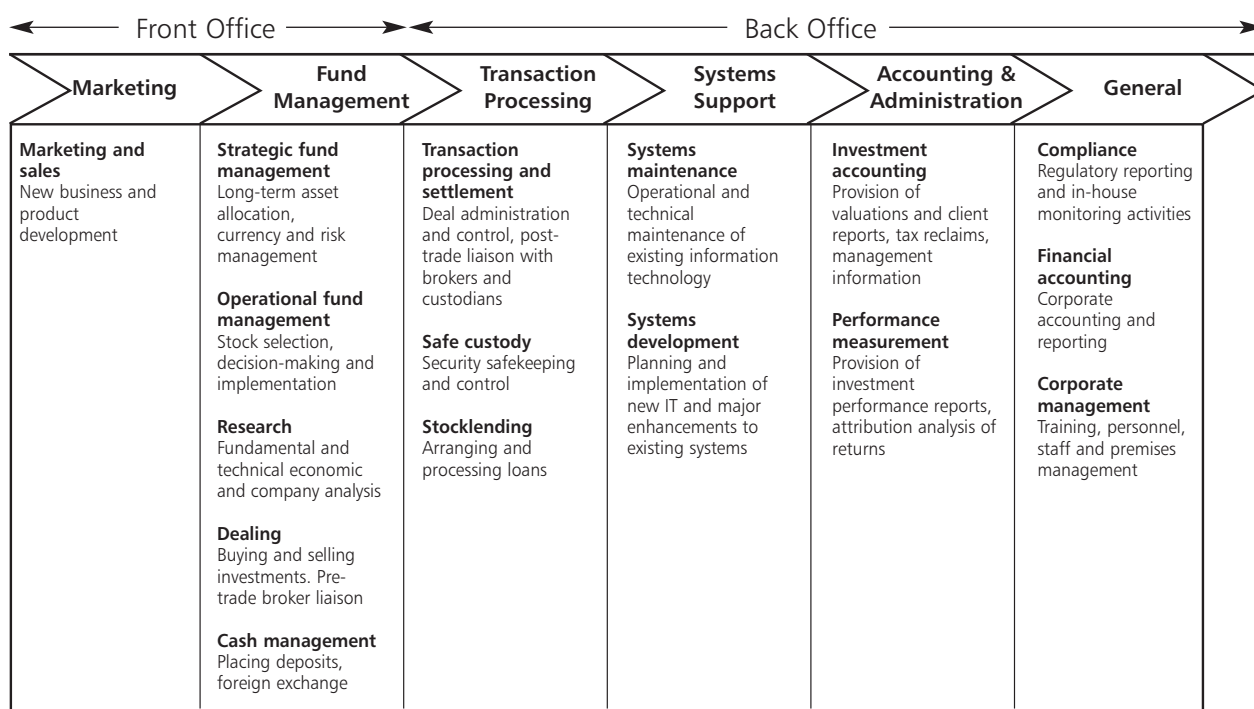
<sup>2</sup> 'Asset allocation' here refers to strategic asset allocation. Fund managers typically undertake some element of tactical asset allocation even where they have a specialist benchmark.

<sup>3</sup> With insurance companies using the term 'client' to include internal clients.

- ‘front office’ functions include the actual activity of buying and selling investments, and various others which surround it, such as the formulation of stock selection and asset allocation decisions, and marketing and selling the firm’s services to clients;
- ‘back office’ functions support these frontline jobs, and include custody (safekeeping of the assets); information systems; systems support and administration.

Figure 5.1 sets out these functions in more detail.

**Figure 5.1: The functions of fund management**



Source: British Invisibles, ‘Fund Management’ (City Business Series 2000: Statistical Update), p.28

5.6 The trend is for unbundling of some of these services – ‘unbundling along the value chain’, as PricewaterhouseCoopers call it.<sup>4</sup> This is partly a matter of firms’ developing expertise in specific areas – for particular asset classes, for example, as pension funds have moved towards awarding specialist mandates. In addition, however, fund management firms are outsourcing an increasing number of functions, such as custody, to other financial institutions, and focusing on the core service of investment and client management. For example, 50 per cent of fund managers used independent custodians in 1997, but this had risen to 71 per cent by 1999. Outsourced activities now account for approximately 10 per cent of managers’ costs.<sup>5</sup>

### **Development of fund management industry**

5.7 In the early days of funded pensions, when institutional assets were relatively small, much fund management was done in-house by the sponsor company, or by its bankers or brokers. Fund management was not yet recognised as a separate discipline.

5.8 As the move to equities gathered pace and institutional assets gradually became larger, independent management firms began to be set up, whose performance showed that investment was not simply about finding a safe pair of hands to look after pension

<sup>4</sup> PricewaterhouseCoopers, *Fire on the Horizon*, 2000, p.4.

<sup>5</sup> Ibid.

contributions. Institutions focused increasingly on the ability of managers to 'beat the market' ('the market' being variously defined). Comparative measurement of managers then grew progressively sophisticated from the early 1980s, in the hands of an emerging investment consulting industry with an interest in picking winners.

- 5.9 By the late 1980s, in-house management had begun a long decline, for a number of reasons. The increasing size and complexity of pension fund portfolios meant that in-house management demanded more resources and expertise than had previously been the case. Moreover, attracting skilled personnel could sometimes be problematic; it was often difficult for pension schemes to offer the remuneration and career structures which independent management firms could provide. Trustees – guided by their investment consultants – began to regard outsourcing management as a cost-effective alternative to these problems.
- 5.10 At this stage, most funds were run on a balanced basis: a single management firm was given responsibility for the entire portfolio of a pension fund, and made the decision as to how to allocate (and reallocate) it between asset classes. Trustees and their consultants evaluated the success of this delegation by comparing the returns earned by any one manager with those earned by the manager's peers: the so-called 'peer group benchmark'.<sup>6</sup> Not surprisingly, the managers hired tended to gravitate to holding the same asset classes as one another, in roughly the same proportions, thus reducing the business risk of losing the account by reason of returns noticeably lower than those of their peers.
- 5.11 In addition to its damaging effects on investment decision-making, as discussed in Chapter 3, the balanced mandate was a force encouraging concentration in the industry. Most pension funds naturally wished to have their money invested by the same small number of management firms: those at the top of the peer group performance league tables.
- 5.12 By the middle of the 1990s, the balanced mandate was seen to have produced disappointing results. Among the perceived problems was the persistent underexposure of most managers to the particularly highly-performing American equity market. Replacing one balanced manager by another, or by multiple balanced managers, did not appear to alleviate the disappointment. This led to a search for managers who might prove to be superior in the way they invested a single asset class. The degree of concentration in the UK pension fund management industry evident in the first half of the 1990s began to unwind: pension funds used a multiplicity of managers as they switched from the pure balanced mandate to a system of specialist mandates, or specialists superimposed on a base of balanced mandates. Market share flattened as fund managers had the opportunity to win some business on the basis of performance in one asset class or lose it on performance in another, rather than winning or losing the whole fund.
- 5.13 The market also saw entry by foreign, largely US, firms as well as consolidation and acquisition of firms by both domestic and foreign purchasers. Restructuring of the ownership of the fund management industry through acquisition activity has been considerable in the last few years, so that many of the firms which were once independent fund managers are now part of wider financial organisations – Mercury Asset Management has become Merrill Lynch Investment Managers, for example (having previously been owned by SG Warburg and subsequently by Swiss Bank Corporation); Morgan Grenfell has been acquired by Deutsche Bank; and Gartmore is now owned by Nationwide Mutual of the US. This has been part of a wider, global consolidation in fund management, which has been going on for some time, and looks set to continue. Table 5.1 shows some of the major transactions which took place in 2000 in the global fund management market, ranked by assets under management.

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<sup>6</sup> See Chapter 3 for a fuller exposition of the characteristics of peer group and customised benchmarks.

**Table 5.1: Top asset management transactions in 2000 by assets under management**

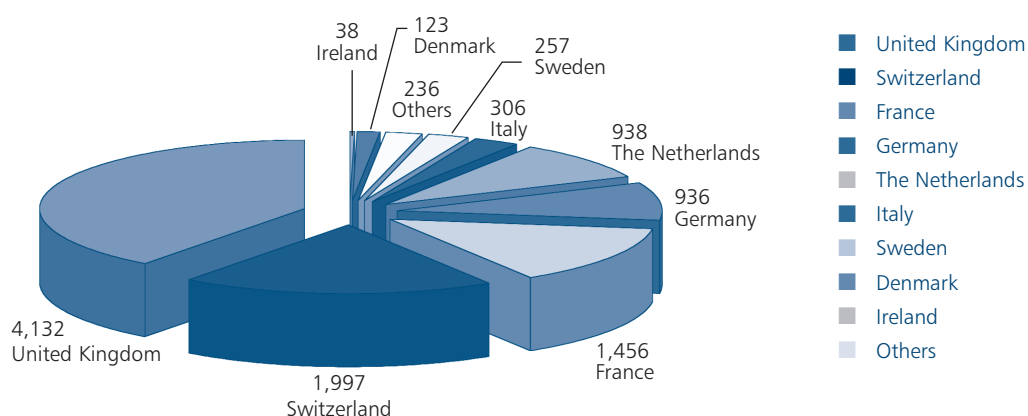
Announcement Date	Entity Sold	Country of Entity		Country of Acquirer	Acquired AUM (millions)	
		Sold	Acquirer		US\$	GBP
June	United Asset Management	US	Old Mutual	UK	203,150	135,433
June	Nvest LP	US	Caisse des Despots et Consignations	France	134,000	89,333
April	Robert Fleming Holdings	UK	Chase Manhattan	US	99,066	66,044
Mar	Gartmore Investment Management	UK	Nationwide Mutual Insurance	US	87,500	58,333
Jan	US Trust Corp.	US	Charles Schwab	US	86,100	57,400
June	Sanford Bernstein	US	Alliance Capital Management, LP	US	86,000	57,333
Sep	Fiduciary Trust	US	Franklin Resources	US	53,239	35,493
Oct	Alleghany Asset Management	US	ABN Amro Holding	The Netherlands	45,000	30,000
Oct	Nicholas Applegate Capital Management	US	Allianz	Germany	43,005	28,670
Oct	Foreign & Colonial Management	UK	Eureko	The Netherlands	38,000	25,333
Oct	Perpetual	UK	Amvescap	UK	17,110	11,407
Oct	Murray Johnstone	UK	Aberdeen Asset Management	UK	6,461	4,307
<b>Total</b>					<b>\$898,631</b>	<b>£599,087</b>

Source: Putnam Lovell Securities Inc.

5.14 At the same time, as funded occupational pensions have become the norm, importantly as a result of Government encouragement, the size of institutional assets has grown exponentially. Assets managed on behalf of UK institutions accounted for over 65 per cent of all funds under management in the UK in 1999.<sup>7</sup>

5.15 Fund management is one of the financial services in which the UK is strong, managing immense volumes of assets – over £2,500 billion – for domestic and overseas clients, both institutional and retail. This success results from a number of factors, including a strong tradition of international investment. The domestic bias for UK investors began to weaken long before that in the US (partly because of the sheer size of the US economy), and UK managers therefore had to develop expertise in managing international equities from an early stage. The UK is one of the largest fund management markets in the world – the biggest being the US, with \$18.5 trillion under management.<sup>8</sup> Figure 5.2 compares the size of the fund management markets in European countries.

**Figure 5.2: Asset management in Europe, by country (\$bn)**



Source: Charterhouse Securities: 'Major Themes in Global Fund Management', May 2000, p.27.

<sup>7</sup> British Invisibles, *Fund Management* (City Business Series 2000: Statistical Update). Figure quoted is £1,672 billion out of £2,555 billion, and relates to funds managed by institutions for clients resident in the United Kingdom.

<sup>8</sup> Figure quoted in Charterhouse Securities: *Major Themes in Global Fund Management*, May 2000, p.89.

- 5.16 London is the home of the vast majority of this business. However, there is also a thriving investment management industry in Scotland: Edinburgh and Glasgow combined were the fifteenth largest management centre in the world in 1999, and the sixth biggest in Europe.<sup>9</sup>
- 5.17 Survey data collected from over 80 of the largest management firms by the Fund Managers' Association finds that they employ over 26,000 people – with approximately 20 per cent of those involved directly in the management of investments.<sup>10</sup> British Invisibles estimate that if smaller firms were included, the total figure for employment in the fund management industry could be over 40,000.<sup>11</sup> Fund management also indirectly supports many more jobs through links with providers of other financial services. Stockbrokers and independent analysts benefit considerably from the services they provide to investment managers. Moreover, the sheer scale of fund management business means that it contributes substantially to the activity and liquidity of UK capital markets and their effectiveness in raising capital for new investment.
- 5.18 British Invisibles make a rough estimate of the value added to the UK economy by the fund management industry, using PricewaterhouseCoopers figures for revenues and costs: approximately £3.8 billion in 1998.<sup>12</sup>
- 5.19 The largest firms in the UK fund management market have many different origins: some are long-established specialists, some with origins in accountancy or law; others are derived from and frequently remain part of UK organisations with a primary focus on banking or insurance; others are under foreign parentage, which may or may not have investment management as the focus of their operations. Table 5.2 sets out the fifteen largest pension fund management firms in the UK by size of pension assets under management, giving an idea of the types of firm involved.

**Table 5.2: Fifteen largest pension management firms in the UK.<sup>14</sup>**

<b>Manager</b>	<b>UK Pension Assets (\$bn)</b>	<b>Market share (%)</b>
Schroders Investment Management	98.8	11.9
Merrill Lynch Mercury Asset Management <sup>13</sup>	96.5	11.7
Barclays Global Investors	73.4	8.9
Phillips & Drew	70.0	8.5
Hermes Pension Management	68.5	8.3
Gartmore	48.9	5.9
Deutsche Asset Management	46.5	5.6
Goldman Sachs Asset Management	33.9	4.1
Hill Samuel Asset Management	22.8	2.8
Prudential Portfolio Managers	20.9	2.5
Foreign & Colonial	16.9	2.0
Fidelity International	16.4	2.0
Henderson Investors	15.5	1.9
First Quadrant	13.2	1.6
Fleming Asset Management	13.1	1.6

Based on figures from William Mercer

<sup>9</sup> British Invisibles, *Fund Management* (City Business Series 2000: Statistical Update), p.1.

<sup>10</sup> Fund Manager's Association: *Fund Management Survey*, 1999, pp.23-4.

<sup>11</sup> British Invisibles, *Fund Management* (City Business Series 2000: Statistical Update), p.14.

<sup>12</sup> British Invisibles, *Fund Management* (City Business Series 2000: Statistical Update), p.14.

<sup>13</sup> Now called Merrill Lynch Investment Managers.

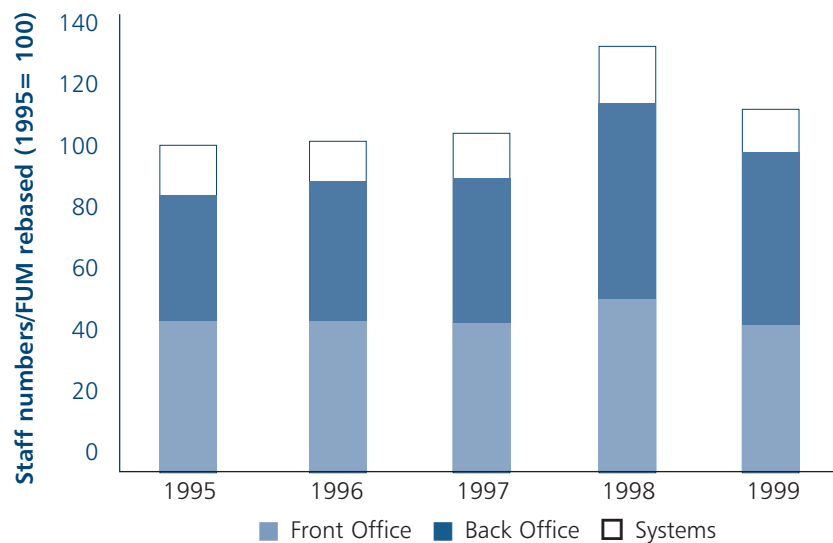
<sup>14</sup> As at 30th June 1998.

5.20 Having established the significance of the fund management industry, the rest of this chapter will focus on that portion of institutional assets representing UK-based pension funds, since UK institutional investors are the main focus of this report, and life insurers are considered directly in Chapter 9.

## Economics of fund management

5.21 Average profit margins for fund management have remained relatively constant over the last five years, at around 30 per cent, despite relatively stable fee levels, rising subscriptions and higher markets.<sup>15</sup> This suggests that managers have experienced difficulty in controlling cost growth, of which the most significant item for most is employment cost. The review has been told that rewards for fund managers have risen at a rate well ahead of that for many other professions, though not necessarily faster than for similar skills in other financial services businesses. Moreover, as Figure 5.3 shows, fund management has become somewhat more labour-intensive over the last five years, with more employees needed to invest the same bundle of assets. This probably reflects added product complexity, increased marketing and client service functions, as well as enhanced investment in controls and governance.

**Figure 5.3: Managing a basket of investments:  
Average number of people required to manage and  
support £1 billion of assets (in 1995 terms)**



Source: PricewaterhouseCoopers 'Fire on the Horizon', 2000

## Competition

5.22 Having set out the key facts about the industry, the first question considered is whether there are grounds for competition concerns in the fund management industry. Measurements of the profitability of a market can be difficult and contentious, so the initial focus of the analysis is on other possible indicators of the level of competition:

- the level of concentration in the industry;
- the nature of the buying process;

<sup>15</sup> Source: PricewaterhouseCoopers, *Fire on the Horizon*, 2000, profit margins here are defined as margin over revenue.



- the nature and structure of fee arrangements;
- the frequency and ease of switching business between managers; and
- ease of entry into the business.

### **Concentration**

- 5.23 Fund management is often thought to be a relatively concentrated industry – and the review raised the question in its consultation document of whether the level of concentration is a cause for concern.
- 5.24 In the latter half of the 1980s, when balanced mandates were the norm, a high degree of concentration developed. However, the rise of specialist mandates, product extension and the increasing use of passive management have meant that concentration in fund management has begun to break down. The figures for UK pension fund management as a whole in Table 5.2 give a Herfindahl-Hirschman index of around 650 – lower than would normally be a cause for concern.<sup>16</sup>
- 5.25 Concentration is only one possible indicator of competition problems, however. In order better to understand how the fund management market works – and whether it raises competition concerns – the buying process for fund management services needs to be examined.

### **The buying process for fund management**

- 5.26 Where specialist mandates are being awarded, a number of crucial choices have usually been made before pension trustees select a manager. There is a prior decision about what proportions of the portfolio to allocate to which asset classes, and a further one of how many managers to employ for each asset class and on what basis. This normally includes the identification of some index of the relevant market for each manager to be measured against. For funds which are managed on a balanced basis, there are one or more balanced mandates to award, and much more autonomy is granted to the manager as to how to allocate assets. The process of manager selection is run in much the same way, however, so any competition issues it raises would tend to apply equally to specialist and balanced management.
- 5.27 Trustees usually hire an investment consultant to assist in their selection of a manager for each mandate. Sometimes there is a search process for the consultant; more typically the trustees use the same consulting firm for all its searches. The consulting firm will either conduct fresh research of management houses for the mandate, or will draw on an existing body of research; the research itself will consist of an analysis of performance figures, supplemented by a qualitative assessment of the manager's capabilities. The consultant then typically draws up a 'long list' of recommended candidates, from which, after discussion, the trustees and consultant select a shortlist to attend a 'final' (the 'beauty parade'). Each potential manager gives a presentation at the beauty parade, and is questioned by trustees, who then decide – with the help of their consultant – which manager(s) to appoint and on what basis.
- 5.28 The central role played by investment consultants in this process is immediately apparent. Most trustees feel uncomfortable about selecting investment managers themselves, because they feel they lack either the experience or the expertise to make this decision themselves.

<sup>16</sup> The concentration in passive management is significantly higher, but this is to be expected, since it is effectively a commodity business where scale is important. It should also be noted that fund management is a global business, so a view based on a national market should in any case be treated with caution. The Herfindahl-Hirschman index for the global fund management business is approximately 100.

Even those who have experience and expertise rarely have the time to conduct qualitative research. Hence the use of consultants. Indeed, manager search activity has been one of the key driving forces spurring the growth of the investment consulting business. However, most consultants are paid on a per-search basis, not for the time explicitly spent in conducting the required research. The result is that they need to prioritise their research efforts and focus them where they are most likely to meet the greatest client demand.

5.29 The review was told on many occasions that consultants tend to expend less research effort on smaller firms, new entrants with only a short performance record, or those which have recently returned poor performance figures, tending to focus on the largest and most established firms. As the following analysis will show, those are the firms that the clients are more likely to choose.

5.30 Trustees tend to downplay the role of past performance numbers in determining manager appointments but this is not borne out by the views expressed to the review by a significant number of fund managers and consultants, as well as by responses to the consultation document:

*'Concentration ... has been reinforced by a preoccupation with recent performance (i.e. last 3-5 years) which, despite worthy statements from consultants and clients alike, continues to dominate the manager selection process.'*

*'Trustees and consultants 'fly below the radar' when they down-play the importance of past performance numbers in their decisions.'*

5.31 Past underperformance tends to be particularly damaging: many respondents felt that managers who have underperformed their benchmark over a period were highly unlikely to be included in long-lists, and even more less likely to be selected by trustees:

*'It appears that most consultants are chiefly driven by recent performance in making recommendations for a shortlist. Although they claim that other factors such as the quality of the investment process or personnel are just as important, in practice the 3-5 year performance track record is the critical consideration in being included on a shortlist. Fund managers may not be fired for bad performance but they are never hired with bad performance. It is inevitable that fund managers need to control their underperformance more than they seek outperformance.'*

5.32 A second major criterion which was often cited to the review as influencing manager decisions is brand:

*'An important element... has been the reluctance of trustees to appoint investment managers whose names are not familiar to them. Trustees have felt understandable concern that they would be criticised for choosing a less well-known manager if he subsequently turned out to produce poor performance, whereas if poor performance was experienced by a well-known manager a significant number of other funds would be affected as well and the blame would be shared.'*

*'Consultants and trustees in the UK have a predilection to work with established and easily recognisable fund management organisations and have not demonstrated a willingness to embrace the idea of retaining lesser-known, yet high-quality, investment management boutiques.'*

- 5.33. It is difficult to be shortlisted for a mandate – and even more difficult to be selected – for a firm which is not well-established, with an unfamiliar name. If trustees are concerned about being held responsible for disappointing fund performance, then investing with a well-known investment management company, which is also the investment manager for many other pension funds, is likely to appear a safe strategy.
- 5.34. However, a buying process focusing on these criteria will naturally tend to produce an industry which is relatively concentrated, as brand and recent success are rewarded.

## Passive investing

Passive management is a low-cost alternative to active management. Instead of seeking to exploit pricing inefficiencies (to 'beat the market'), passive managers normally hold everything in an index, in exactly the weighting it appears in that index, and hope to benefit from growth across the market.<sup>17</sup> In other words, they have a zero tracking error, no 'benchmark risk', and make no stock selection bets. This style of management has become progressively more common in the last few years: approximately 20-25 per cent of UK institutional funds are now passively managed.

Passive management can be carried out far more cheaply than active management. It does not require a large research staff, because its output is not a series of investment judgements, and economies of scale provide considerable advantages to major suppliers. Although there is a substantive question about which index a manager tracks for a given market, and increasingly complex methods of execution have been developed, passive investing is essentially a commodity. Its most significant impact on the market for active investment management has been on fees, because active managers have had to compete against the availability of a cheap passive product.

As an investment strategy, passive investing seeks to free-ride off the more or less efficient capital allocation of active fund managers. As such, it could in principle lead to odd pricing effects. However, it would not be legitimate to argue on that basis that institutions should not use it. Their concern is not with the efficiency of the capital markets as a whole, except insofar as this may affect the interests of their beneficiaries. Passive investing is a legitimate strategy for an investor who values its tangible cost advantages over the possibility of achieving additional return through superior stock selection.

The greater one's belief in the efficiency of the market concerned, the more convincing this argument is likely to be. Indeed, a rational investor might expect to invest passively in some markets but not others, on the basis that they believed that one market, because of poor liquidity, lack of information and similar factors, held opportunities for active investment to add value, whereas other markets, with high liquidity and good information, did not.

The decision about whether to have active or passive management is a strategic one, which investors must take asset class by asset class.

## **Management fees and costs**

- 5.35 There appears to be little direct competition within active fund management on the basis of fees, although some downward pressure on fee levels is exerted by the availability of passive management as an alternative. Funds and their advisers sometimes negotiate price reductions, and there is some evidence that they are placing increasing emphasis on this

<sup>17</sup> Some passive managers do not hold exactly the index, but use replication techniques with the intention of producing the same effect.

element of the buying process. There has traditionally been some tapering of fees, with the management of marginal tranches of mandates offered at lower price. However, it remains the case that fees are not a central decision criterion; a second-choice active manager is highly unlikely to be chosen on the basis of offering a lower fee.

- 5.36 Most strikingly, there is virtually no competition on the basis of *type* of fee arrangement. The *ad valorem* fee, through which managers are paid a small percentage of the funds they have under management, is almost universal as a mode of manager remuneration, in the UK and elsewhere.
- 5.37 At the same time, international comparisons tend to rate the UK reasonably on the prices charged by fund managers. For example, the ranges of fees charged in different countries for a £100 million mandate in equities and the same size mandate in fixed interest (and the corresponding size mandates in other countries, for example, US \$150 million) are as follows:

**Table 5.3: Management fees charged in different countries for a £100 million mandate<sup>18</sup>**

	Basis Points per annum							
	Canada		UK		Australia		US	
	Equities	Fixed interest	Equities	Fixed interest	Equities	Fixed interest	Equities	Fixed interest
Upper quartile fee	28	22	48	23	47	22	50	30
Median fee	24	18	40	18	44	19	42	26
Lower quartile fee	21	16	30	17	40	18	33	2 3

Source: Frank Russell Company

### ***Ease of switching***

- 5.38 Another possible source of competition concerns could be the ease or difficulty of switching between managers. If there is no realistic possibility of a firm losing business to a competitor, it has little incentive to innovate, or to keep prices low.
- 5.39 There are certainly transaction costs involved in switching managers: not only the cost of the selection process, but also the costs of switching portfolios. Relative to the sums involved, however, they are not an insuperable barrier. Figures suggest that manager switching is relatively active and at a level not dissimilar to that experienced in other geographies for institutional fund management.
- 5.40 The review's survey of trustees found that overall, one-third of schemes had changed investment manager in the past 12 months (though of course this may be one of many managers). There seems to be some size effect: 64 per cent of trustees from smaller funds said they had not changed their manager for more than three years (this probably reflects the fact that fewer small funds use specialist management and the generally lower level of resources which smaller funds are able to bring to the manager selection decision).<sup>19</sup>

<sup>18</sup> These figures may be calculated on a different basis in different countries, and therefore may not necessarily be comparable. They are provided here as a guide.

<sup>19</sup> The rate of switching also varies considerably from year to year.

5.41 Of course, switching investment manager need not in itself be a good thing. Switching costs money, not only to conduct the search but also because the switched portfolio requires sales and purchases of securities, and attendant transaction expense, to reshape it in line with the new manager's preferred dispositions. Thus ill thought-out switches of mandate from one manager to another could be just as harmful to a fund as unthinking loyalty to an investment management firm. However, purely from a competition point of view, high levels of switching suggest that concentration is not necessarily an indication of lack of competition in the market.

### ***Ease of entry***

5.42. Ease of entry is also a relevant consideration. The situation here is mixed. There has been entry into the UK industry in recent years, although it is noticeable that these have typically been firms that are already major names in the US market such as Capital International, Fidelity and JP Morgan. This is consistent with the buying process sketched out above, in which the ability to show favourable past performance figures, significant resource and a well-established brand is important.

### ***Conclusion on competition issues***

5.43. The review does not believe that there are grounds for major competition concerns in the fund management market, for a number of reasons:

- the level of concentration which existed when balanced management was the norm has begun to break down;
- fees for fund management in the UK do not appear to be especially high relative to those in other countries;
- switching between firms is relatively simple and frequent; and
- some new firms have been successfully able to enter the market in recent years.

## **Possible sources of investment distortions**

5.44. However, although the review does not raise conventional competition concerns, its investigations of the fund management market have identified a number of areas of policy concern. In particular, although competition between managers is relatively intense, the *basis* on which they compete – and the incentives created by this process – may not be conducive to optimal investment decision-making.

### ***Selection of fund managers***

5.45 Selecting managers according to past performance figures first and brand second is widely acknowledged to be a poor way to select a manager.

5.46 In the first place, past returns are no indication of future performance, for a number of reasons. One is simply luck. A manager selects securities in the belief that the market has mispriced them. Whether the market corrects itself within the time period under measurement, particularly if it is a short or ill-defined period, is often a matter of chance. A second factor is that the manager's approach, or 'style', may be particularly favoured by the market during the period under measurement – or may be particularly hard-hit.<sup>20</sup> A third factor is that there may be an optimal size at which a manager can continue to generate outperformance using its existing personnel, strategy and so on. As the assets under management grow, new personnel need to be found who can replicate their colleagues' past success at stock selection on a larger scale; and a larger pool of assets is difficult to manage to beat the market.

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<sup>20</sup> Though clients can seek to mitigate this by using a style index for evaluation purposes.

- 5.47 A strong focus on historical performance clearly has damaging consequences. Research confirms anecdotal evidence that there is a marked tendency for managers to be hired at the top of their performance cycle, and fired at the bottom:

*'selection takes place in the main after a period of significant outperformance by a manager. This outperformance appears more likely to erode quickly as be maintained. In other cases the manager released will turn performance around in the period after the change. Real pain will set in for those funds who appoint a manager at the top of his cycle and remove a manager who then turns performance around.'*<sup>21</sup>

- 5.48 It is important to distinguish between optimal *decision-making* and optimal *decisions*. The optimal *decision* – the selection of the most successful manager – can be achieved only with hindsight. But a persistent tendency of the manager selection process to hire the wrong manager at the wrong time is a sign of sub-optimal decision-making.
- 5.49 This can be linked to a number of factors identified in earlier chapters. The limited investment expertise and time of trustees is one likely factor; the lack of measurement of the impact of manager selection advice is another.

### ***Incentives for fund managers***

- 5.50 The second issue in connection with possible sources of investment distortion is whether fund managers have appropriate incentives.
- 5.51 The most important incentives on a fund management company come from two sources:
- its fees. These are on an *ad valorem* basis. In other words, the greater the growth in the value of the portfolio, the larger the manager's fee; and
  - the benchmark and outperformance targets which it is set.

### ***Incentive effects of fee structures***

- 5.52. The *ad valorem* fee is the most common fee structure in every country in which occupational pension funds are managed by external fund managers. Managers are paid a percentage of funds under management, with the result that they are rewarded not specifically for adding value relative to the benchmark, but for an increase in the size of the portfolio, which might equally be caused by a rise in the value of the market as a whole, something which they do not control. In its consultation document the review therefore raised the question of substituting performance-based fees, which would reward managers more directly for outperforming their benchmark. But while such arrangements may be theoretically preferable, US experience of them has not been particularly successful (see box). The review does not therefore have further proposals to make in this area.

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<sup>21</sup> The WM Company, *Does Changing Manager Improve Performance?* 1996; *Does Changing Manager Improve Performance?: An Update*, 1998.

## US experience of performance fees

Performance fee arrangements were experimented with in the US in the latter half of the 1980s. The typical fee structure used was of the fulcrum type: the manager received the traditional *ad valorem* fee level for an agreed amount of outperformance, but greater outperformance earned more (subject to a ceiling of, for example, twice the traditional *ad valorem* fee), while underperformance reduced the fee (subject to a floor of, for example, one-quarter of the traditional *ad valorem* fee).

At the time, there was widespread concern that these arrangements created a separation of interests as regards the risk taken (the so-called 'tracking error') in the portfolio. Where a manager is outperforming a benchmark during a particular evaluation period, it is in their best interests to lock in that gain by reducing the tracking error, or degree of portfolio conviction, for the remainder of the period. Conversely, if the manager is underperforming the benchmark during an evaluation period, they have an incentive to increase their volatility by taking larger bets in an effort to recover from that loss against benchmark.

Overall, there is little evidence that incentive fees changed performance patterns, either for better or for worse.<sup>22</sup>

### **Objectives and benchmarks**

- 5.53 The main effect of the *ad valorem* fee is that the principal financial incentive on the fund manager is not to lose the account, further reinforcing the importance of the benchmark used.
- 5.54 The nature of the benchmark is crucial in driving manager incentives. Its precise effects differ depending on the nature of the benchmark, which in turn depends on the decision-making model used by the pension fund: a peer group or an index (or combination of indices). As set out in Chapter 3, a balanced mandate is typically associated with a peer group benchmark; a specialist mandate will use a customised/index benchmark.
- 5.55 The incentives on asset allocation decision-making created by peer group benchmarking were considered in Chapter 3. The following paragraphs analyse the impact of index benchmarking on the security selection decision.

### **Index benchmarks**

- 5.56 The function of a market index in this context is to assess how a portfolio performed relative to the relevant market – with the index serving as a proxy for that market.
- 5.57 However, there is inevitable arbitrariness at the margins, about which stocks come to be included in an index – in particular because of the qualitative nature of asset class distinctions.

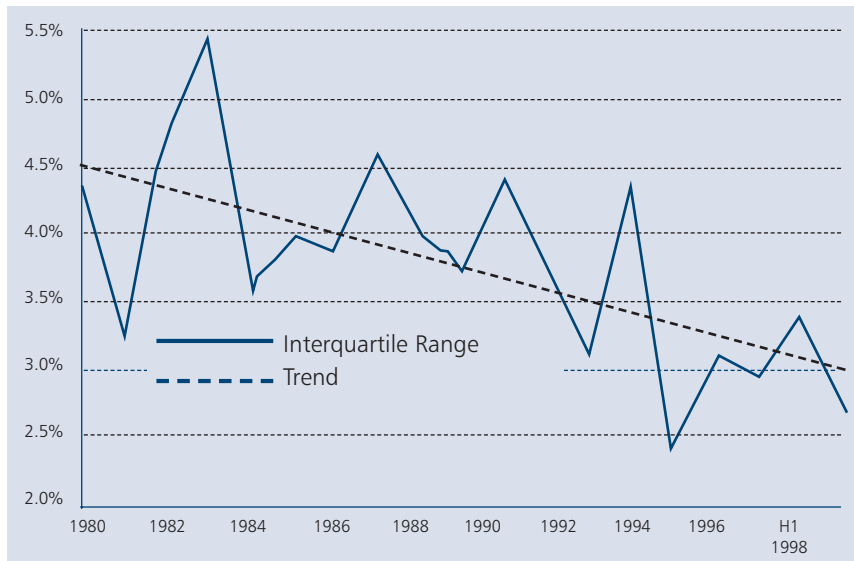
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<sup>22</sup> One aspect of the experience was that the definition of the benchmark assumed great importance; indeed, it helped to create a new line of business, that of customising benchmarks to define, as precisely as possible, the opportunity sets of securities of managers with different approaches.

- 5.58 For example, in 2000, when Vodafone acquired Mannesmann via a share exchange arrangement, managers with a UK equity mandate sought to buy additional Vodafone shares to reflect its increased weight in the UK market. Had Mannesmann acquired Vodafone (which in theory would have been quite possible, given their similar size) resulting in essentially the same corporate entity but one listed on the German stock market, the same managers would have sold the shares of 'Mannesmann-Vodafone', since it was a German security and therefore not in the UK stock market index.
- 5.59 This sort of arbitrary decision cannot be entirely avoided. It does, however, lead to two clear conclusions.
- 5.60 First, it is essential that pension funds understand how the various indices in a market are constructed. They should actively decide which of the available indices is the best proxy for an asset class, given the role played by that asset class in their strategic asset allocation policy. A selection of a particular index is an important investment decision. Managers should be proactive in identifying to clients where the choice of a particular index has created incentives to follow a sub-optimal investment strategy.
- 5.61 Second, the recent trend to set increasingly tight limits in tracking error (divergence from the benchmark) is unhelpful. The underlying rationale is sound: that pension funds, having made an asset allocation, need to set limits to divergence from the index in order to prevent the fund manager taking security selection bets of such a size that their asset allocation policy is negated. A manager given a UK equity mandate who then invested it entirely in four UK stocks would be investing the money in a very different way to that intended by the fund when it decided to allocate that sum to 'UK equities'.
- 5.62 But funds which put in place tracking error limits must take account of the fact that an index is only a subjective and approximate representation of an asset class. To set tight limits around divergence from it forces managers to alter their portfolio in response to arbitrary changes at the margin in the composition of the index – buying Vodafone shares because it had acquired Mannesmann, but selling Vodafone shares if Mannesmann had acquired Vodafone. These transactions are driven by changes in the composition of the index, not by the manager's view of the merits of Vodafone shares as an investment. This is a distortion.
- 5.63 Furthermore, where a fund has concluded that a market will repay active management, it should pursue that approach with conviction, setting challenging targets for outperformance against the index but also allowing sufficient divergence from that index to encourage genuinely active management to occur. At the present moment, the reverse appears to be happening. Figure 5.4 below suggests that as performance measurement of fund managers has grown and become increasingly sophisticated since the 1980s, the returns of active managers have progressively converged. The shift away from peer group benchmarking and balanced mandates does not seem to have incentivised managers to pursue divergent strategies, tailored to the varying investment objectives of different institutions or their own distinct approach to investment: quite the reverse. Rather, many pension funds seem to be paying active fees for management which increasingly resembles passive management in its style, adding (and indeed aiming to add) less and less value, and offering less and less innovative stock selection strategies.



**Figure 5.4: The narrowing dispersion of UK equity returns**



Source: CAPS Trustee Survey of UK pension funds  
Outperformance of the lower quartile actively managed UK equity portfolio by the upper quartile

**The review therefore recommends that funds should:**

- **explicitly consider, in consultation with their investment manager, whether the index benchmarks that they have selected are appropriate; in particular, whether the construction of the index creates incentives to follow sub-optimal investment strategies;**
- **set limits on divergence from the index which reflect the approximations involved;**
- **consider explicitly for each asset class invested whether active or passive management would be more appropriate; and**
- **where they believe active management to have the potential to achieve higher returns, set both targets and risk controls which reflect this, allowing sufficient freedom for genuinely active management to occur.**

## Risk budgeting

Risk budgeting is the measurement of a portfolio's or a fund's potential risk exposure in each of several areas, followed by the allocation of a certain portion of the fund's aggregate risk tolerance to each of the areas. The risk budget defines the extent to which the investor is willing to allow exposure of the portfolio to investment risk. Having made the investments, good performance of the assets can increase the risk budget and poor performance reduces it.

This allows the conscious allocation of risk exposure to those areas that are deemed most likely to reward risk-taking; and the aggregation of different types of risk into a single overall measure that is consistent with the total fund's risk tolerance. Risk measurement methodologies of this kind can help investors to understand the relationship between the risks they are taking in different parts of their portfolio in seeking to achieve their overall investment objectives.

## **Timescales**

5.64 The issue of the timescales over which benchmarks are used to assess performance is also important. The accusation that 'the City is short-termist' has been around for a long time, taking various different forms. In the case of institutional investors, the culprit traditionally cited (and respondents were no exception in this) is the quarterly trustees' meeting, which drives quarterly appraisal of managers' performance and in turn makes fund management firms' internal appraisal and monitoring systems focus strongly on quarterly performance:

*'the use of relative return objectives over short time periods as the major component of decision-making about manager appointments is detrimental to the long-term health of pension funds.'*

*'performance time horizons for pension fund mandates are generally too short with the effect that, for example, a three-year rolling objective means that in practice one year of severe underperformance can lead to a serious risk of termination of the mandate. This increases the incentive to hug the benchmark and seems at odds with the long-term liabilities of the fund.'*

5.65 The review encountered three responses to these propositions.

5.66 Some respondents from pension funds and other institutional clients or their advisers argued that the situation was being misrepresented. While pension funds (and indeed other institutions) did look at the quarterly results, they did not actually change managers or investment strategy on the basis of a single quarter or even several quarters. This was entirely appropriate: it would be wrong to make decisions purely on the basis of the short term, but not to look at short-term performance at all would be a mistake. The fault lay, according to this view, with fund managers who misinterpreted their clients' wishes.

5.67 Others argued that there was indeed a focus on short-term performance which was regrettable, but that this was the inevitable consequence of pension funds holding quarterly meetings. Trustees could hardly be expected not to look at the figures, and a natural human reaction of unease set in if performance remained poor for several quarters.

5.68 A third response argued that if there was a focus on quarterly figures, this was not necessarily wrong as 'the long term is composed of a series of short terms' – in other words, that consistent delivery of good short-term performance was the best way to deliver good long-term performance.

5.69 None of these arguments is altogether reassuring. The important issue, however, is not attempting to determine whether pension funds do or do not have an 'excessive' focus on quarterly performance driven by the fact that they meet quarterly. It is simply not possible to arrive at an objective answer to this question. Nevertheless, there are three clear facts:

- a large number of fund managers believe that their pension fund clients are very concerned by short-term performance;
- a number of pension funds and their advisers insist that they are not; and
- pension funds will inevitably look at quarterly performance figures.

5.70 The review believes that what is lacking in these circumstances is clarity. If clients are – as at present – extremely vague about the time horizons over which managers' performance will be judged, managers will, perfectly rationally, assume that they *could be* dismissed after *any* quarter's performance.

- 5.71 This lack of clarity is not in anyone's interests. If haziness over timescales means that, in practice, fund managers' incentives do not reflect the actual objectives of their client, they are likely to adopt investment strategies that yield sub-optimal results. This could also lead to inefficiencies in the capital markets. Some investment judgements which rely on the market correcting a mispriced valuation may well take longer than one or two quarters to show results. Yet fund managers, if given no clarity over how their performance is to be judged, may well be artificially discouraged from taking the risk of waiting for that long.
- 5.72 A further unfortunate consequence of lack of clarity on timescales is the weakening of incentives for managers actively to tackle underperformance of companies, which tends to require some length of perspective.

**The review therefore recommends that pension funds should provide fund managers with clarity about the period over which their performance will be judged – and hold to that under the terms of the contract, unless clearly abnormal circumstances arise.**

### Stamp duty

The issue of stamp duty has been raised with the review by a number of respondents. This is not surprising. By its nature, taxation can have a very significant effect on behaviour. This is particularly true in capital markets, where the activity being taxed is highly mobile and where small differences in costs between different jurisdictions can have significant impact.

This is also an area where change is rapid. The process of innovation in the capital markets creates new financial instruments constantly, many of which can have very different tax treatments with similar economic substance for investors. Globalisation and cross-border integration continues apace, with obvious implications for nationally-based tax regimes.

It is clear that stamp duty is an important issue for the Government, and it would be remiss of the review not to identify it as such. The combination of a potentially significant impact on behaviour and rapid pace of change in the environment mean that it is important that the Government should monitor developments in financial markets closely, to ensure that informed action can be taken quickly where necessary.

### *Shareholder activism*

- 5.73 There has been considerable movement in recent years – in the light of the work of the Cadbury, Greenbury and Hampel committees, culminating in the publication of the Combined Code of the Committee on Corporate Governance in July 1998 – towards an activist stance on certain corporate governance issues by institutional investors. This is to be welcomed.
- 5.74 These developments have brought a variety of benefits for shareholders and for the economy at large. Nevertheless, while helpful, these initiatives are not always sufficient. It remains widely acknowledged that concerns about the management and strategy of major companies can persist among analysts and fund managers for long periods of time before action is taken.
- 5.75 Conversely, some have pointed the review towards the performance of a small number of specialist funds targeted on identifying and investing in underperforming companies as a precursor for lobbying for change, as evidence of value opportunities being forgone as a consequence of inaction by other investors.

- 5.76 The review is not making a public interest argument about shareholder responsibility. The most powerful argument for intervention in a company is financial self-interest, adding value for clients through improved corporate performance leading to improved investment performance. One would expect that for institutional investors with long-term liabilities, such an approach to investing would appeal.
- 5.77 In investigating these issues, the review encountered a number of arguments.
- 5.78 *'We are not in a position to second-guess corporate management.'* This seems surprising for an industry in which managers are highly remunerated precisely for analysing and making judgements on corporate performance, including the soundness of corporate strategy and the competence of top management. Of course, shareholders cannot micromanage the companies in which they have holdings, but that is not what is suggested: simply that, where they identify problems, they should actively engage with the company to ensure that they are tackled rather than merely waiting and hoping that action will be taken. This is not micromanagement.
- 5.79 *'We are already doing it. We have an active corporate governance policy and meet investee companies regularly.'* The issue here is partly one of language. Active engagement with issues of corporate governance (through implementation of a voting policy in accordance with the Combined Code, for example) can be a worthwhile and important activity. But it is not the same as active intervention. Nor is meeting investee companies, valuable though this is. As those managers who do engage with investee companies make clear, intervention requires persistence and a thick skin, perhaps raising issues repeatedly over a period of time with firmness until concerns are addressed. Merely meeting senior management and expressing polite reservations about strategy is not sufficient, if it is not effective.
- 5.80 *'There is no need for such a strategy – if we don't like a company, we just sell the shares.'* Of course there are many occasions when selling its entire holding in the shares is likely to be the appropriate response for a fund. In practice, however, this is often difficult where the share price is already depressed, or when it is believed that a zero holding cannot be adopted for other reasons (such as constraints on departures from an index benchmark). Nevertheless, numerous industry participants, in discussions with the review, suggested that large shareholders who could not possibly sell without affecting the price nevertheless showed a marked reluctance to intervene in situations where companies were clearly experiencing strategic and leadership problems. Moreover, there is often little advantage for the institutional investor in what Warren Buffett has called *'gin rummy managerial behaviour – discard your least promising business at each turn'*.<sup>23</sup>
- 5.81 *'There are regulatory difficulties – we would become insiders, for example.'* In general, fear of potential regulatory difficulties was often raised by industry participants at the beginning of discussions, but proved somewhat hard to pin down more precisely. The concerns appear overstated. Of course, managers have to avoid any question of insider trading, and will have to exercise judgement about when information they have received – in the course of discussing a firm's strategy with the board, for example – is price-sensitive. However, having a meeting with a company to discuss (and possibly seek to influence) its strategy need not make a manager an insider. Moreover, where a decision has been made not to sell a holding in the short term, but to attempt to encourage the company to improve its performance, a

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<sup>23</sup> Warren Buffett: Chairman's Statement in Annual Report of Berkshire Hathaway, 1983.

manager should not mind becoming an insider in the short term, particularly if the patience required to see such an approach work was not placed at risk by the possibility of early termination of the manager's mandate.

- 5.82 Other respondents raised fears about co-operation between a number of active shareholders triggering takeover rules about concert parties. The review was told of no situation where this had happened; nor could it easily conceive of one. It finds the argument lacking in substance.
- 5.83 The review concludes that the most important explanations lie elsewhere. First, current manager selection and performance measurement processes can mean that there is little incentive to adopt activist strategies, which do not deliver the quick results which a perceived focus on quarterly figures tends to demand.
- 5.84 Second, there is a culture in the financial community of wanting to avoid public confrontation with companies: not wanting to be seen to have lost confidence in them, or their management. Voting levels have risen in recent years, but are still low.<sup>24</sup> But votes against a board are very rare – and usually prompted by some dramatic or particularly well-publicised event. By that time it is usually too late.
- 5.85 Third, the review was told by some that there was real potential for conflicts of interest. Fund management firms may be keen to attract or to keep a contract to manage the pension of the company in question – or they may be part of a wider financial organisation, which wants, for example, the investment banking or insurance business of that company. Similarly, the argument was made that firms may generally not want to be seen publicly (in particular by the press) as 'troublemakers', in the interests of attracting new business.
- 5.86 The Company Law Review makes similar arguments in its consultation document, *Completing the Structure*:

*'If the managers manage a company pension fund, anything less than unquestioning support for that company's board may lead to loss of the business, since a majority of the trustees are usually directors or former directors of the company. If the fund manager is part of a banking or financial services group, the company management may threaten to terminate banking or other relationships.'*

*'But the most common agency problem arises from fund managers' own business interests. At any time some sponsoring companies of pension fund clients may be underperforming. Directors are unlikely to welcome shareholder activism from the manager. Even those doing well may be hostile to such activism as future discipline.'*<sup>25</sup>

- 5.87 Clearly, where managers were failing to take an activist stance because of their wider business interests, they would be illegitimately subordinating the interests of their clients to other aims. Management firms have a responsibility to ensure that the reality as well as the appearance of effective Chinese walls is established, protecting their clients' interests in improving the performance of companies they own, from their wider business interests.

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<sup>24</sup> The NAPF-sponsored Report of the Committee of Inquiry into UK Vote Execution found that they had risen to 50 per cent in 1999, from 20 per cent in 1990.

<sup>25</sup> *Modern Company Law: Completing the Structure*, 2000, p.72.

- 5.88 Finally, there are concerns that other investors might free-ride off the efforts of the intervening manager. To the extent that fund managers are seeking to outperform their peers, this is a problem for them. But it is not a problem for their clients, and as such should be irrelevant: a manager's duty is to do the best for their clients. If others benefit too, this is not a reason for inaction.
- 5.89 The final point highlights the central issue – that effective intervention, when appropriate, is in the best financial interests of beneficiaries. As such, it is arguably already a legal duty of both pension fund trustees and their fund managers to pursue such strategies. US legislative guidance makes it clear that activism – where it might add value – is a part of the fiduciary duty of an investment manager. The following interpretative bulletin was published by the Department of Labor in 1994. It is worth quoting at length, because it spells out the relationship between the investment duties of a manager, and activist behaviour – and some of the specific issues on which engagement may be appropriate.

### US Department of Labor Interpretative Bulletin<sup>26</sup>

'The fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock.'

'The fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan's investment.'

'An investment policy that contemplates activities intended to monitor or influence the management of corporations in which the plan owns stock is consistent with a fiduciary's obligations under ERISA when the responsible fiduciary concludes that there is a reasonable expectation that activities by the plan alone, or together with other shareholders, are likely to enhance the value of the plan's investment, after taking into account the costs involved. Such a reasonable expectation may exist in various circumstances, for example, where plan investments in corporate stock are held as long-term investments or where a plan may not be able to easily dispose such an investment.'

'Active monitoring and communication activities would generally concern such issues as the independence and expertise of candidates for the corporation's board of directors and assuring that the board has sufficient information to carry out its responsibility to monitor management. Other issues may include such matters as consideration of the appropriateness of executive compensation, the corporation's policy regarding mergers and acquisitions, the extent of debt financing and capitalisation, the nature of long-term business plans, the corporation's investment in training to develop its workforce, other workplace practices and financial and non-financial measures of corporate performance. Active monitoring and communication may be carried out through a variety of methods including by means of correspondence and meetings with corporate management as well as by exercising the legal rights of a shareholder.'

The bulletin also articulates the fact that managers must not allow themselves to be influenced by conflicts of interest:

'fiduciary duties . . . require that, in voting proxies, the responsible fiduciary consider those factors that may affect the value of the plan's investment and not subordinate the interests of the participants and beneficiaries in their retirement income to unrelated objectives.'

<sup>26</sup> Interpretative bulletin relating to statements of investment policy, including proxy voting policy or guidelines, Code of Federal Regulations Table 29 Chapter XXV, 2509. 94-2, 1994.

- 5.90 The review believes that the US Department of Labor Interpretative Bulletin (see box) correctly articulates this element of the duty of care which fund managers owe to their clients: in particular, the principle that ‘the fiduciary obligations of prudence and loyalty to plan participants and beneficiaries require the responsible fiduciary to vote proxies on issues that may affect the value of the plan’s investment’. Managers should routinely consider the possibility of intervening in investee companies as one of the means of adding value for their clients.
- 5.91 In this regard, it would be helpful if pension funds themselves recognised the possibility of added value through intervention, and regularly sought evidence from managers to demonstrate that they were active in this way.
- 5.92 The pension fund clients of investment managers have a right to expect them to 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. Managers may need to augment their skill base and communication processes to rise to this challenge.

**The review recommends that all pension fund trustees should incorporate the principle of the US Department of Labor Interpretative Bulletin into fund management mandates. It also recommends that the principle should in due course be more clearly incorporated into UK law.**

- 5.93 The review does not believe that the Department of Labor principle means compulsory voting in all cases; nor is it the review’s intention that managers should invariably exercise votes on all their shares, however unthinkingly. But voting is one of the central means by which shareholders can influence the companies in which they have holdings, and the review believes that a culture in which *informed* voting was more universal is very much to be desired.
- 5.94 More broadly, non-executive directors of a company are now placed at the heart of corporate governance. Fund managers should take an active interest in their appointment and performance, exhibiting vigilance in determining an appropriate degree of independence and a proper level of engagement.

### **Regulation of fund managers**

- 5.95 Fund managers are authorised by the Investment Management Regulatory Organisation (IMRO), now under the auspices of the Financial Services Authority (FSA), which is in the process of integrating its operations with the various separate regulatory organisations.
- 5.96 To be authorised by IMRO, firms have to demonstrate that they are, and will remain, fit and proper persons to undertake investment business of the kind proposed. The ‘fit and proper’ test encompasses:
- the honesty and integrity of the firm, its directors, managers, staff and any controlling shareholders;
  - the experience, qualifications and competence of its management;
  - the adequacy of its financial resources;
  - its ability to conduct investment business of the kind proposed honestly, fairly and competently; and
  - its ability to comply with IMRO’s rules.

- 5.97 Firms are required to establish systems for ensuring observance of all relevant rules, for the reporting of key facts to the regulator and reporting their financial condition periodically. They are subject to a disciplinary system which involves being ready to co-operate at all times with any requests for information, or any investigation from the regulator. They must also pay their share of the costs of running the regulator.
- 5.98 The role of IMRO is one of the responsibilities that is being subsumed within the enlarged FSA. During this transitional period, IMRO now relies on its service agreement with the FSA to carry out its regulatory responsibilities. The FSA regulates the financial services industry and has four objectives under the Financial Services and Markets Act 2000 (FSMA): maintaining market confidence; promoting public understanding of the financial system; the protection of consumers; and fighting financial crime. The FSMA also requires the FSA to have regard to a set of principles of good regulation including a proportionate approach to rule-making, facilitating innovation in the financial sector and ensuring that regulatory requirements do not distort competition. The FSA aims to maintain efficient, orderly and clean financial markets and help retail consumers achieve a fair deal.
- 5.99 The FSA's intention is to create a single set of prudential requirements organised by risk (for example market risk, credit risk and insurance risk) rather than according to categories of financial services firm (for instance building societies, banks, investment managers). These revised requirements are not planned to be introduced until 2002. Until then, the prudential material in the FSA Handbook sets out interim requirements which largely restate the current position, but adjusted to reflect the FSA's new regulatory duties and powers under the FSMA. The FSA published for consultation a draft Interim Prudential Sourcebook for investment firms (IPRU(INV)).<sup>27</sup>
- 5.100 The approach which the IPRU(INV) adopts is to delete those provisions which gave IMRO an element of discretion in the application of the rules. Firms are also able to apply to the FSA for a waiver of any such rule. Consequently, the FSA envisages that this will not result in any significant changes for firms in practice.

### ***Skills and Training***

- 5.101 The review welcomes the fact that the fund management industry is moving towards increasing the professional skills of those employed in the industry. In particular, the Chartered Financial Analyst examination is becoming increasingly popular, with almost 2,000 people registered to take it in 2001. This is a rigorous examination including a strong ethical element, and – importantly for the review's concerns – covers a wide range of investable assets, including private equity. It is encouraging that the number of people taking this higher qualification in addition to the threshold competence Investment Management Certificate recognised by the FSA, is growing.

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<sup>27</sup> CP54, The Investment Business Interim Prudential Sourcebook, June 2000.



## Skills: credit analysis

In a world of lower inflation and doubts over whether the historic outperformance of equities can be maintained, fixed interest investments are likely to be an increasingly important area for fund managers. This is likely to be further strengthened by the growing maturity of defined benefit schemes and the increasing demand for predictable return investment as a result.

The UK fund management industry is having to develop its skill-base to respond to this trend. The historical combination of high levels of gilt issuance and high inflation has meant that long-term investment in a variety of fixed-interest investments has had little opportunity to develop in the UK. The market has been dominated by gilts investment and by the use of fixed interest as a tactical rather than as a strategic investment. UK fund managers have not until recently invested in developing expertise in this area, in contrast to the US, where fixed interest has always been a much deeper and a more significant market.

The traditional 'poor relation' status of fixed interest within fund management companies is likely to change in response to the market trends above. Fund managers will need to build up enhanced quantitative and credit skills as the depth and breadth of the market expands away from its previous dominance by gilts. This, in turn, will facilitate the issue of a greater variety of sterling debt investments by UK corporates.

### ***Other issues: broking commissions***

- 5.102 The fee which UK pension funds pay to their fund manager is subject to considerable scrutiny by trustees and their investment consultants. They will seek to negotiate it when hiring fund managers, and it will be a factor which they take into account when considering whether to have funds managed actively or passively. The annual fee is clearly visible. Comparisons are made between countries on the level of these fees, and the competitiveness of UK fees are cited as a success by investment consultancy firms.
- 5.103 Pension funds using active managers will in many cases be paying a similar annual sum in commissions to sell-side investment houses, stockbrokers and so on, for providing dealing and research. This expenditure is incurred on the client's behalf by the fund manager. Commissions are added to the cost of purchase or deducted from the proceeds of sale and settled against the pension funds's account with its custodian. In other words, they are paid directly by the pension fund.
- 5.104 Yet the treatment of these costs is different to that of the fund management fee in two important respects.
- 5.105 First, although they are disclosed, this is done in a way which is far from transparent. The aggregate cost to a fund of commissions over a period is not something which must necessarily be calculated. Rather, disclosure to the client is on the note confirming the transaction, not a document of particular interest to trustees.
- 5.106 Second, the firms which provide the services for which commission is charged are selected by the fund manager, acting as the agent for the institutional client. The client has no direct involvement in the decision, and the process by which these fees are negotiated is not transparent to the client. Some (not all) fund managers have put in place a formal assessment process for determining the quality of service they receive from the sell-side firms to whom they give business. Their incentive to target price paid as part of this process is the impact that commission levels have on fund performance. While helpful, this is not the same as more direct pressures on business costs.

- 5.107 There is an *a priori* case that this system creates an artificial bias for fund managers to have services provided by the sell-side, distorting competition, since the costs for these will not be scrutinised by the client and are not a direct charge to the fund manager's profit. In effect, the fund manager outsources a business input to the sell-side with the cost charged directly to the client.
- 5.108 Clients' interests would be better served if they required fund managers to absorb the cost of any commissions paid, treating these commissions as a cost of the business of fund management, as they surely are. Fund managers would of course seek to offset this additional cost through higher fees; this would be a matter for them to agree with their clients. Under this system, the incentives would be different. Institutional clients would see more clearly what they were actually paying to have their funds invested. Incentives for them to manage costs would apply equally to all costs, as opposed to acting on some more than on others, as at present. Fund managers would choose which services to buy and which to provide themselves.
- 5.109 Under this arrangement fund managers would face a commercial tension between wishing to cut costs on the one hand, but wanting to achieve superior investment returns on the other. This is healthy. The pressure would be to purchase only those services which contributed to such returns, and to do so in the way which is most efficient.
- 5.110 Fund managers would determine those services they wished to acquire from external specialists and contract on a basis that reflected the perceived value of input. Such contracts could be fixed in price for a period, linked to transaction values or on a hybrid basis. This would be a matter for the contracting parties to determine.
- 5.111 This model would not favour fund managers over broking businesses the provision of large fund managers over small. Any organisation which could add value through the provision of efficient and effective investment services, whether fund managers or broking businesses, large or small, should succeed in this environment. Indeed, this model may attract new service providers, promoting greater diversity of input and service.
- 5.112 To the extent that fund managers directed greater resource to developing their own research capabilities, particularly in company research, there may be a collateral gain in terms of improved governance as a result of greater contact between fund managers and corporate management.
- 5.113 Adoption of this recommendation would mean that current inefficiencies and complexities associated with practices such as soft commission<sup>28</sup> and commission recapture<sup>29</sup> would be likely to cease.

**The review recommends that it is good practice for institutional investment management mandates to incorporate a management fee inclusive of any external research, information or transaction services acquired or used by the fund manager rather than these costs being passed on to the client.**

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<sup>28</sup> 'Soft Commission Arrangements' covers the process by which a client authorises a firm to generate 'soft' credits by executing its investment transactions through nominated brokers under the terms of a soft commission agreement. 'Soft' credits are then used to pay for goods or services which can reasonably be expected to assist in the provision of investment services to the firm's customers and which in fact are so used. The FSA primarily regulates these activities by requiring firms to a) ensure that 'soft' credits are not obtained at the expense of achieving best execution and b) periodically disclose to clients the scope and financial materiality of their soft commission arrangements.

<sup>29</sup> An agreement made by the Pension Scheme with a commercial provider whereby the latter, for a fee, establishes arrangements such that the Scheme receives credits from commissions for securities transactions made by its Investment Managers on its behalf. The credit is often employed to pay for goods or services purchased by the Scheme rather than injecting cash into the assets of the Scheme directly. Commission Recapture is usually regarded as synonymous with Directed Commission.

## Conclusions and recommendations

5.113 The review concludes that the level of competition in the fund management market is sufficient not to raise conventional competition questions.

5.114 However, the review's examination of fund management has raised a number of other policy concerns about the incentives placed on managers by current methods of manager selection and measurement. In particular:

- excessive reliance on performance figures in manager selection tends to lead to sub-optimal decision-making;
- lack of clarity about the timescales over which managers are being assessed;
- the current use of risk management and index benchmarking encourages inappropriate levels of attention to risks of little relevance to funds and active management that increasingly resembles passive; and
- managers are failing to add value to client holdings through reluctance to intervene in investee companies where appropriate.

5.115 The review has therefore made the following recommendations in this chapter:

### **Funds should:**

- **explicitly consider, in consultation with their investment manager, whether the index benchmarks that they have selected are appropriate; in particular, whether the construction of the index creates incentives to follow sub-optimal investment strategies;**
- **set limits on divergence from the index which reflect the approximations involved;**
- **consider explicitly for each asset class invested whether active or passive management would be more appropriate; and**
- **where they believe active management to have the potential to achieve higher returns, set both targets and risk controls which reflect this, allowing sufficient freedom for genuinely active management to occur.**

**Funds should provide fund managers with clarity about the period over which their performance will be judged – and hold to that under the terms of the contract, unless clearly abnormal circumstances arise.**

**All pension funds should incorporate the principle of the US Department of Labor Interpretative Bulletin into fund management mandates. The principle should in due course be more clearly incorporated into UK law.**

**The review recommends that it is good practice for institutional investment management mandates to incorporate a management fee inclusive of any external research, information or transaction services acquired or used by the fund manager rather than these costs being passed on to the client.**

## CHAPTER 6:

# Defined Contribution Schemes: specific issues

### Introduction

- 6.1 Defined contribution pensions currently account for a relatively small proportion of pension fund assets. They will become increasingly important, however, as they play an ever-growing role in new pension provision. Their different structure has important implications for investment decision-making.
- 6.2 This chapter:
- considers why defined contribution is likely to be the dominant model for future pension provision;
  - analyses the implications of some key features of defined contribution pensions – in particular, the shift of investment risk to individuals, the absence of risk-pooling and the need for liquidity;
  - looks at the role played by both trustees and individuals in investment decision-making; and
  - briefly discusses some other issues raised by the investigation, such as contribution levels.
- 6.3 In the course of the analysis the review makes several proposals. There are also a number of issues which are covered by proposals set out at the end of Chapter 9, on life insurance.

### The shift to defined contribution

- 6.4 For nearly 30 years, the main growth in pension assets under management has been in large defined benefit schemes. But from the early 1990s, defined benefit schemes began increasingly to be closed to new members, or even to wind up. This resulted from a number of factors, including the increasing cost of defined benefit pension provision. As one submission to the review said:

*'DB pension provision has become progressively less attractive to employers through (inter alia):*

- *the requirement to guarantee Limited Price Indexation pension improvement;*
- *the imposition of the MFR;*
- *the likely imposition of FRED 20<sup>1</sup>; and*
- *the removal of the tax credit on dividends.'*

- 6.5 Moreover, long-term shifts in labour market practices meant that job mobility and working-life flexibility increased, and defined benefit schemes began to look increasingly inappropriate. When a member of a defined benefit occupational scheme moves employer,

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<sup>1</sup> Now implemented, as FRS 17.

either complicated actuarial judgements have to be made about the value of that worker's accrued rights, or the individual will acquire a series of small defined benefit accounts, one for each occupational scheme to which he or she has belonged.

- 6.6 The review does not seek to pass judgement on whether these changes – in pension regulation, tax policy and the labour market – were desirable. Arguments can certainly be made in favour of each one. The important point is that they were in large part responsible for a very significant shift in the nature of pensions provision so that now, essentially all new pension schemes are defined contribution. This will have increasingly important impacts on investment by pension schemes.
- 6.7 The nature of pension schemes means that the shift to defined contribution will take a long time to feed through to the stock of assets under management. By any estimate, the great majority of pension fund assets are still in defined benefit schemes and this will continue for many years to come. According to the National Association of Pension Funds (NAPF) Annual Survey<sup>2</sup>, 13 per cent of schemes are currently defined contribution; but as most of these schemes are immature, the proportion of assets accounted for by defined contribution will be much lower.
- 6.8 Defined benefit schemes remain an extremely important area of both pension provision and capital flows. But there is no doubt that the future is likely to rest with defined contribution schemes. It is therefore crucial that the review considers them and the way in which investment decisions are made on behalf of their members.
- 6.9 As a general point, the review has found that data on defined contribution pensions are much more limited than those available for defined benefit, because of the relative size and newness of the market.

**The review recommends that the NAPF investigate ways of collecting more comprehensive data on the investment decisions of defined contribution schemes.**

## Key features of defined contribution schemes

- 6.10 In contrast to defined benefit schemes, defined contribution schemes have several key features with important implications for investment:
- members bear the investment risk;
  - the scheme must be able to provide a valuation of each member's account at short notice, either for information purposes or to enable members to move their pensions account to a different scheme, normally in connection with a change of employer; and
  - there is no pooling of members' risk, as there is with defined benefit schemes.
- 6.11 These points of difference bear further analysis.

## Investment decision-making

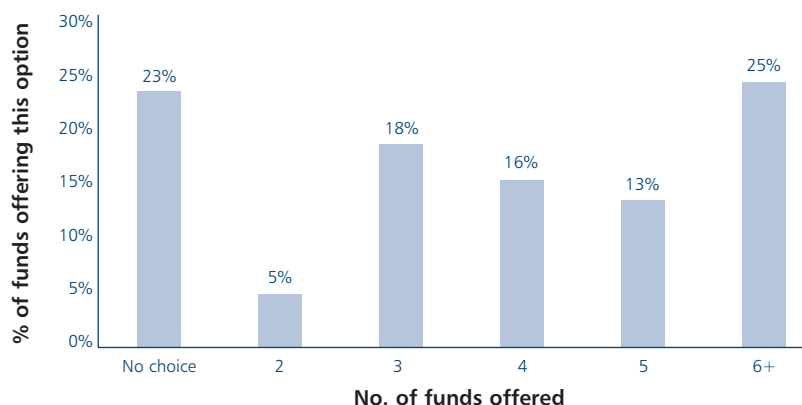
- 6.12 In a defined contribution scheme, the individual member bears the investment risk. This does not mean, however, (as is often assumed in simplistic discussions) that the individual makes the investment decisions. Such data as there are suggest that this is far from the case.

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<sup>2</sup> NAPF Annual Survey 1999, p4.

- 6.13 In the first place, a number of defined contribution schemes offer only one investment option to members. According to the Watson Wyatt 2000 Pension Plan Design Survey, 23 per cent of schemes surveyed offered no choice. A survey by Towers Perrin suggests the figure may be higher.<sup>3</sup> In all these cases, the individual makes no investment decision.

**Figure 7.1: Number of funds available in defined contribution plans**



Source: Watson Wyatt 2000 Pension Plan Design Survey.

- 6.14 Even where a range of options exists, many funds offer a default option. Indeed, the regulations for stakeholder pensions require such an option to be offered. Where there is a default option, members are not required to make a decision about where their money will be invested. Expressing no preference automatically selects the default option. A number of respondents suggested that default options were very popular:

*'We gave a wide variety of choices...and all staff wanted the trustees to make the decision for them. Not all members of the public are interested in investment decision-making.'*

*'In our experience virtually all DC schemes have a default in place and most members use it – the majority of our clients see over 75 % of members going into the default option and many believe the figure to be significantly higher.'*

- 6.15 The use of lifestyle options is also relevant. Under such an approach, the funds are gradually switched from equities to bonds as the member approaches retirement. Although members are typically asked when the switch to bonds should start, they are unlikely to be making most of the investment decisions. According to one survey, 38 per cent of lifestyle strategies use managed funds, where asset allocation decisions are taken by the provider<sup>4</sup>. One survey found that where a lifestyle option was offered, in 90 per cent of cases it had a take-up rate of 75 per cent or more.<sup>5</sup> The Barclays Global Investors 1999 Client Survey stated:

*'The increase in lifestyling, as a scheme choice and as a default, was evident. (Over 50% of those schemes that used lifestyling had more than a 90% take-up rate.) This shows that the most popular option is the one where the members are not asked to make the investment decision. We have seen a significant increase in the number of schemes now prepared to offer lifestyling as the default option.'*

<sup>3</sup> 'over 60% of survey respondents...provide members with a choice.' Towers Perrin, *Defined contribution pension arrangements in the United Kingdom*, February 2000, p.16.

<sup>4</sup> Towers Perrin, *Defined contribution pension arrangements in the United Kingdom*, February 2000.

<sup>5</sup> Barclays Global Investors, *1999 Client Survey*, Issue 1, April 2000.

- 6.16 The review is concerned that the equity-bond switch which is the key feature of lifestyle funds is often undertaken mechanistically, without adequately taking into account factors such as increased longevity rates and differential risk appetites.
- 6.17 This is part of a wider issue: that the majority of members in defined contribution schemes do not in practice take any of the investment decisions relating to their funds. Even where they do select from one fund or another, the scheme typically offers them a choice of only four or five funds, so some element of the asset allocation decision has already been made.
- 6.18 This raises the question: if individuals are not taking these investment decisions, who is? The answer depends on the scheme's legal basis. Defined contribution pensions can take two basic institutional forms<sup>6</sup>:
- Occupational money purchase schemes. These are defined contribution schemes provided by the employer and administered by a trust, much as defined benefit schemes are – indeed, often the same trust administers both types of scheme.
  - Group Personal Pensions (GPP). As the name suggests, these are similar to personal pensions and typically are provided through a commercial contract with a pensions provider regulated by the Financial Services Authority (FSA). They enable companies to provide their employees with defined contribution pensions without setting up a trust.
- 6.19 In occupational money purchase schemes operating as trusts, the trustees largely undertake investment decision-making. In GPPs, it is the pensions provider.
- 6.20 The remainder of this chapter therefore considers the issues raised by:
- trustee involvement in investment decision-making;
  - involvement by commercial pensions providers; and
  - the role of individuals.
- 6.21 First, though, it considers the other two features of defined contribution schemes outlined above: the absence of risk-pooling and the need for liquidity and fair pricing.

## Stakeholder pensions

It is not yet clear what impact the introduction of stakeholder pensions will have on investment decision-making. Many responses suggested that the 1 per cent per annum cap for charges may encourage passive management and deter investment in alternative asset classes such as private equity; but innovative and competitive solutions may be produced by managers committed to securing a share of this new sector.

The investment regulations that will govern stakeholder pensions mirror those for trustee schemes, including the requirement to produce a Statement of Investment Principles (SIP) and to have regard both to diversification and to suitability in developing an investment strategy.<sup>7</sup>

Stakeholder schemes will be able to offer members a choice of investments. When they do so, however, they must still provide a default option, as individual stakeholder members

<sup>6</sup> In addition, individual personal pensions are also sometimes included in the category of 'defined contribution pensions'. Additional voluntary contributions or free-standing additional voluntary contributions are similar in nature to personal pensions, adding a defined contribution element to a defined benefit scheme. There are also smaller categories of executive pension plans/ unapproved schemes, such as self-invested personal pensions and small self-administered schemes, which the review has not investigated in detail.

<sup>7</sup> The Stakeholder Pension Scheme Regulations 2000. No.1403.

cannot be required to make an investment choice.<sup>8</sup> A number of respondents to the review expected that a high proportion of stakeholder pensions would be invested in the default option, as evidence from existing defined contribution schemes suggests. The same issues about the range of investment options available and decision-making therefore apply to stakeholder schemes as to conventional defined contribution schemes: for example, about choosing the default fund.

Alternatively, the employer may simply offer access to a stakeholder-compliant scheme provided by a financial institution (an insurance company, for example). In this case, that institution's decision-makers will be responsible for investment decision-making. The issues raised in Chapters 5 and 9 therefore apply.

### ***Absence of risk-pooling***

6.22 Risk-pooling genuinely helps to reduce risk. As they do not pool risks, defined contribution schemes should quite properly invest more conservatively than equivalent defined benefit schemes, regardless of whether decisions are being taken by individuals or on their behalf.

6.23 To a certain extent, the absence of a sponsor's guarantee is also a proper reason for investing a defined contribution pension more conservatively, as various respondents argued:

*'The cross-subsidies within DB schemes, surplus assets (where they exist) and the willingness of the plan sponsor to bear any shortfalls in funding enable DB schemes to invest more aggressively than DC schemes.'*

*'The nature of DC pension provision is such that it is highly likely that the monies will be invested more conservatively. In order to fund – at a particular date – the tax-free cash lump sum and the purchase of an annuity, an individual would logically move into cash and gilts in a way that would not be required in an on-going DB scheme.'*

6.24 However, this argument needs to be treated with some caution. The implied assumption is that individuals are always less well placed to absorb investment underperformance than sponsors of defined benefit schemes. This is not necessarily the case. A defined benefit scheme with liabilities large enough to have a serious financial impact on the sponsor should perhaps invest rather more conservatively than an individual for whom the defined contribution pension forms only part of his or her anticipated retirement income. Such circumstances are likely to be unusual, but nevertheless serve to highlight the fact that generalisations about the risk appetite of different groups can be misleading.

### ***Need for liquidity and fair pricing***

6.25 Portability is another key feature of defined contribution provision. As a result, defined contribution schemes need to invest in assets with a clear market price so that they can offer equitable treatment to those subscribing to or withdrawing from the fund and, those remaining in the fund. Liquidity therefore becomes a consideration – it must be possible to price the assets fairly. This has specific implications for private equity investing which are considered below.

<sup>8</sup> Reg.3 (3).



# The role of trustees and pension providers in investment

## **Trustees**

- 6.26 Trustees' involvement in defined contribution raises many of the same issues already considered in relation to defined benefit schemes:
- trustees' level of investment expertise;
  - the resources they are able to bring to bear on their responsibilities; and
  - the incentives they create for fund managers through performance measurement.
- 6.27 These have already been discussed in previous chapters. Asset-liability modelling is not carried out for defined contribution schemes. As they make no defined pensions promise, they have no measurable liabilities. But the absence of liabilities as such only serves to highlight further questions about how and on what basis trustees set an investment strategy for the fund's default option.
- 6.28 A trustee structure also raises some specific issues for defined contribution schemes. In many cases, it is used because it is convenient for the employer. If the employer is one of the many switching from defined benefit to defined contribution, there is an organisation in place (the trust) to which it can delegate at least some of the burdens of decision-making on pension provision.
- 6.29 In a defined benefit scheme, the investment risk falls on a single organisation – the sponsor. It is feasible for the trustees to establish the sponsor's appetite for risk and to invest accordingly. But in defined contribution schemes, the risk falls on individuals, each of whom is likely to have very different risk preferences. It is not practical for trustees to take account of the individual risk preferences of each individual member. This would seem to point towards giving members maximum choice. But it is quite clear that many members have only limited understanding of and interest in the management of their pension, and are neither particularly competent nor in many cases willing to take investment decisions themselves. Offering a very wide range of options might lead to even greater confusion. As trust law requires trustees to act in the best interests of members, they are in any case pushed in the opposite direction: trying to take a large part of the investment decisions affecting the assets of the scheme.
- 6.30 There is no easy way of resolving this tension. It is not clear, for instance, how trustees should decide which options to offer, and how many. The more they offer, the less likely it is that members could successfully claim their investment choice had been restricted. But equally, the more options they offer, the more complicated the decision becomes for members, who may therefore find it easier to argue that trustees have not acted in their best interests. There is no guidance on these issues and little in the way of legal precedent.
- 6.31 In the US, the Department of Labor has addressed this by issuing 'Safe Harbor' regulations for defined contribution plans offering a choice of investments. The plan must offer at least three alternatives; each must be diversified and have different risk/return characteristics; the choices must allow participants to create a portfolio appropriate to that individual; and each combination must minimise the overall portfolio risk through diversification. Participants must be able to control their assets and be able to change their investment choices. There is also a requirement for the type of information that must be made available.

The review recommends that investment decisions taken on behalf of defined contribution scheme members should accord with the principles set out in Chapter 11. In particular:

- a) where a fund is offering a default option, trustees should ensure that an objective is set for the option, including expected risks and returns; and
- b) when selecting investment options, trustees should:
  - take into account members' preferences; and
  - ensure that they offer a sufficient range of funds to satisfy the risk and return combinations reasonable for most members.

### ***Commercial pension provision***

- 6.32 Where there is no trustee structure, defined contribution schemes are managed by commercial pensions providers, typically life insurance companies. These schemes raise much the same investment-related and consumer concerns as apply to the life insurance industry generally (see Chapter 9). These are covered by the proposals at the end of Chapter 9 on the life insurance industry, and
- 6.33 the review believes that the principles set out in Chapter 11 should also apply.

## **The role of the individual in investment decisions**

- 6.34 The quality of information and advice available for members is an important issue. A number of respondents questioned the quality of information currently available:

*'It is very rare for members of DC schemes to be given a clear and meaningful description of the investment fund choices being offered to them. Essential details about fund objectives, benchmarks, performance targets and investment management style are all too often overlooked or ignored. Members are often just given recent investment performance data at regular intervals and then, quite wrongly but understandably, make investment decisions based on this performance.'*

- 6.35 Some change is taking in place in this area. In December 2000, the FSA published 'decision trees' for the introduction of stakeholder pensions to help individuals make choices. However, these help people decide whether a stakeholder pension scheme is appropriate, not how their money should be invested once that decision is made. Some schemes already have websites providing useful information. As more schemes develop websites there will be increasing pressure to upgrade the breadth and depth of information provided. Surveys show that increasingly, schemes are planning to use the internet to communicate with their members. The review strongly encourages this.
- 6.36 There is also wider work going on in this area. One of the FSA's statutory objectives is to protect consumers and promote public understanding of the financial system. There have been several welcome initiatives to support this objective, including:
- the 'Consumer Help' section of the FSA website, which provides simple explanations of financial products and services, consumer rights and responsibilities and updates on market and regulatory developments;
  - organising the first FSA annual education conference and encouraging the effective teaching of personal finance in schools; and

- the distribution of more than 750,000 factsheets and booklets both through the FSA itself and through Citizens' Advice Bureaux, public libraries and MPs' constituency offices.
- 6.37 The FSA has been supported by the Personal Finance Education Group (PFEG). The PFEG aims to promote and facilitate the education of all UK school pupils about financial matters so that they are able to make independent and informed decisions about their personal finances and long-term security.
- 6.38 The FSA spent some £5.2 million on consumer relations in the year ended 31 March 2000. This represents just under 5 per cent of the total cost of mainstream regulatory activity. Given the importance of financial awareness for individuals, this is an area which the FSA should continue to build up. The FSA and others should be alert to the opportunity to facilitate greater use of workplace education about pension and investment matters, a model which has worked well in the US.

## Other Issues

### ***Investment by defined contribution schemes in private equity***

- 6.39 Although detailed data on the investment patterns of defined contribution schemes are not available, a number of respondents told the review that there has been no significant investment in private equity by defined contribution schemes.
- 6.40 Two possible reasons were cited for this. One was the volatility of such investments. A number of respondents argued that as individuals are inherently more risk-averse, they would not (or even should not) invest in private equity. As one response put it:
- 'Specialist funds such as venture capital funds with high potential returns but significant volatility are unlikely to be attractive (to DC schemes) unless: (a) the member has already accumulated a substantial DC pot or (b) he/she wishes to adopt a very aggressive strategy at the early stage of their career.'*
- 6.41 The seeming prevalence of this view is a matter for concern. Investments in the most volatile of assets may not be appropriate for a significant part of an individual's pension portfolio or for the portfolio of an individual close to retirement. But it does not follow that only the young and highly risk-hungry can or should invest in assets such as private equity.
- 6.42 In terms of timescale, ten years from retirement is ample time to realise returns from a private equity portfolio. And as far as volatility is concerned, a holding of say 3 to 5 per cent of the portfolio is unlikely to pose any significant risk to retirement income.
- 6.43 In terms of risk, individuals or even possibly schemes as a whole may feel, on consideration of the opportunities presented by private equity, that it is not a sensible investment choice for their fund to offer at a particular point. This is surely legitimate. But it cannot be right to argue that an asset class is by its nature too risky to form any proportion, however small, of the scheme's overall investment offering. There is a danger here that just when more defined benefit schemes are coming to reject as irrational an investment strategy that ignores certain asset classes on the grounds that they are 'too risky', defined contribution schemes may repeat similar mistakes.

6.44 The issue of liquidity is a second reason cited for the reluctance of defined contribution schemes to invest in private equity. It is true that the limited partnership form is particularly problematic in this respect. However, defined contribution funds can avoid this problem by investing in investment trusts that specialise in private equity. While not the dominant form of private equity investment, there are currently some eighteen UK venture and development capital trusts<sup>9</sup> in existence, and over the long term, greater interest in them from institutions would encourage the private equity industry to consider structuring more vehicles in this or other forms likely to appeal to defined contribution investors.

**The review recommends that defined contribution schemes should, as a matter of best practice, consider a full range of investment opportunities, including less liquid and more volatile assets.<sup>10</sup> In particular, investment trusts should be considered as a means of investing in private equity.**

6.45 There could also be more innovative approaches which would permit defined contribution schemes to invest in private equity. It is not the role of this review to design products, but for example, one could envisage an approach under which defined contribution investors would direct regular sums of money into a feeder fund. While this fund was accumulating, the assets would be invested in a passive equity fund. Once sufficient funds were accumulated and establishment of the private equity vehicle was complete, the index portfolio would be liquidated as and when required to finance new investments by the private equity fund. The defined contribution investor would either receive funds back on realisation from the private equity portfolio or the scheme promoter would establish a facility where proceeds would again be invested in a passive portfolio pending establishment of a new private equity vehicle. This brief description does not tackle all the possible issues raised by such a vehicle, but it serves to indicate that there is scope for greater innovation in this area.

### ***Contribution levels to pensions***

6.46 Concern has frequently been expressed to the review that contribution levels to defined contribution (as opposed to defined benefit) schemes are too low to provide the sort of retirement income anticipated by most people. Evidence from the NAPF Annual Survey 2000 appears to support this:

- for 76 per cent of defined contribution scheme members, employers were contributing at less than 5 per cent of salary; while
- the proportion of private defined benefit scheme members for whom employer contributions are below 5 per cent is only 43 per cent.

6.47 Of course, the maturity profiles of the two types of scheme are very different. But the difference is too great to be explained by this. Moreover, as a number of defined benefit schemes have surpluses, one might reasonably expect them to have lower employer contributions, not higher.

6.48 This is clearly related to most people's poor level of understanding of financial issues. However, it is also an issue in its own right.

6.49 This raises broader issues of pensions policy which go beyond the direct remit of this review. However:

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<sup>9</sup> Information provided by the Association of Investment Trust Companies.

<sup>10</sup> This (applied to all pension schemes) is one of the principles of institutional investment: see Chapter 11.

**The review recommends that the Government should keep under close review the levels of employer and employee contributions to defined contribution pensions, and the implications for retirement incomes.**

## **Conclusions**

- 6.50 Not enough reliable information is available on defined contribution pension schemes. This is a relatively poorly understood sector, where more comprehensive data need to be collected on a consistent basis.
- 6.51 There are sound reasons why the investment patterns of defined contribution schemes should be more conservative than those of defined benefit schemes – not least, because all investment risk falls on the individual. At the same time, some less sound reasons appear to have gained excessive weight and influence.

**The review has therefore recommended that:**

- **the NAPF investigate ways of collecting more comprehensive data on the investment decisions of defined contribution schemes;**
- **investment decisions taken on behalf of defined contribution scheme members should accord with the principles set out in Chapter 11. In particular:**
  - a) **where a fund is offering a default option, trustees should ensure that an objective is set for the option, including expected risks and returns; and**
  - b) **when selecting investment options, trustees should:**
    - **take into account members' preferences; and**
    - **ensure that they offer a sufficient range of funds to satisfy the risk and return combinations reasonable for most members;**
- **defined contribution schemes should, as a matter of best practice, consider a full range of investment opportunities, including less liquid and more volatile assets. In particular, investment trusts should be considered as a means of investing in private equity; and**
- **the Government should keep under close review the levels of employer and employee contributions to defined contribution pensions, and the implications for retirement incomes.**

## CHAPTER 7:

# Pension Fund Surpluses

### Introduction

- 7.1. This chapter considers an issue specific to defined benefit schemes: ownership of any surplus generated by the fund, over and above the assets required to meet its liabilities. Whether the sponsoring company can consider that it 'owns' (some or all of) such assets will clearly have a powerful effect on the interest it takes in the pension fund. This in turn will crucially determine the resources and expertise that it makes available for managing the fund.
- 7.2. At present, sponsors face an asymmetry. They are rightly responsible in full for any deficit on the fund (at least up to the limit prescribed by the Minimum Funding Requirement (MFR). But as the analysis below shows, they have an uncertain and partial right to any surplus. This has three important effects.
- 7.3. First, it gives the sponsor – to the extent that it influences the investment approach of the fund – an incentive to favour a more risk-averse strategy than it otherwise might. If employers have a limited amount to gain from the pension fund's *outperformance*, it is concerns about potential *underperformance* that are likely to dominate in their attitude to the fund's investment. This is a distortion. Their views should reflect symmetrically their interest in outperformance and their wish to avoid underperformance, whatever those might be.
- 7.4. Second, it may further discourage employers from offering defined benefit schemes, to the extent that they bring risk without reward.
- 7.5. Third, where they continue to offer defined benefits, the employer has less incentive to take an interest in the efficient management of the scheme's investments, as it is more difficult for them to benefit from any investment gains. As respondents said:
- 'If pension funds were permitted without fiscal penalties to sustain larger surpluses, their appetite for asset classes with higher risk and return could improve.'*
- 'outstandingly strong performance may result in lower contribution rates, but equally may result in improved benefits to pensioners, especially in the case of mature schemes. Conversely, poor performance impacts only on the sponsor, who must increase contribution rates. This scenario does not encourage risk-taking, and provides a confusing set of objectives for the trustees.'*
- 7.6. The importance of this argument has been perhaps insufficiently appreciated. Partly as a result of the Maxwell affair, pensions policy to date has generally viewed the sponsor's involvement in a trust's affairs as likely to be against the interests of beneficiaries and therefore to be prevented as far as possible. While understandable, this is one-sided in its emphasis.
- 7.7. Although funds must clearly be protected from sponsor abuse, sponsor interest in a fund's financial performance can also be a vital force for good. As Chapter 2 identified, the sponsor (or, more specifically, the sponsor's finance function) should offer an important source of support for a pension fund. As well as acting as a source of investment expertise and

experience, it may make extra resources available (personnel, for example) in order to ensure that the fund is properly managed.

- 7.8 For all these reasons, the question of employers' access to surpluses is an important one for the review.

## **Legal and regulatory background**

- 7.9. The chapter begins by setting out the legal background to the issue of the surplus. After briefly describing the different bases for valuing fund assets, and tax treatment, it goes on to seek to explain the legal confusion surrounding this issue and analyses its implications.

### ***Implications of trust law in general***

- 7.10. In law, trustees 'own' the assets of a trust. They hold them in trust for the beneficiaries. The assets have originally derived from a 'settlor' who will have set out the conditions for their use in a trust deed. In most trusts, the trust deed expresses the settlor's interests. In a family trust, for instance, the settlor will usually settle property outright, by way of gift, on fixed trusts that are normally incapable of variation. The settlor is under no duty to make any further transfers to the trust (although may do so if they wish). Nor does the settlor have any continuing financial interest in the fund.
- 7.11. Pensions trusts are much less clear, for various reasons:
- the employer has a continuing interest in the scheme, unlike a settlor as originally conceived in law;
  - scheme members may also contribute from their earnings, unlike classic beneficiaries; and
  - the pension trust is open-ended, with a constantly fluctuating membership.
- 7.12. In addition, the nature of the employer's interests depends on whether the scheme is set up as a shared-cost or a 'balance of costs' scheme. In the case of a shared-cost scheme, contribution rates for both employer and employee will vary according to actuarial requirements. In the case of a 'balance of costs' scheme, the employee's contribution rate will be fixed as a percentage of salary, while the employer's contribution will vary according to the need for funding.
- 7.13. Most large defined benefit schemes are 'balance of cost'. In such schemes, the trust deed and rules should specify the extent and nature of the parties' entitlement to any surplus, but they do not always do so clearly. The result has been a number of disputes over who owns fund surpluses.
- 7.14. It should be noted that a series of judgments by the European Court of Justice has to some extent compounded the lack of clarity in this area. These judgments have found that occupational pensions operate as 'deferred pay' schemes (in the context of Article 119 of the Treaty of Rome and of the Equal Pay and Equal Treatment Directives flowing from that Article). This has encouraged employee representatives to believe that any plan surplus is also 'deferred pay' and owed to them.

### ***Specific pensions legislation***

- 7.15. As set out above, the trust deed and rules should ideally specify the employer's interest in any surplus. But they do not always do so, and even when they do, company mergers and acquisitions create situations where the intention of the trust deed in the new circumstances is unclear.

- 7.16. The Pensions Act 1995 helped to clarify the position to some extent. When a scheme winds up, after all the statutory requirements for benefits and guarantees are met, section 77 of the Pensions Act 1995 states that, in the case that either a decision has been made not to distribute the assets to the employer or the scheme prohibits such a distribution, (a) the trustees must use those assets for the purpose of providing additional benefits or increasing the value of any benefits, but subject to prescribed limits, and (b) the trustees may then distribute any remaining assets to the employer. In other words, the employer is the *residual* owner of the assets. But this does not prevent debates over attempts to pay the surplus to the employer at an earlier stage in the process.

### Valuation of pension funds

In considering the surplus, there is of course the question of how it is calculated. UK pension funds are able to provide valuations using five different methods:

- an actuarial valuation on the basis that the fund is ongoing. The basis for this is a matter of actuarial good practice;
- an actuarial valuation on a discontinuance basis, that is, a more conservative one, also based on actuarial good practice;
- an MFR valuation, which values the assets and liabilities according to the rules specified in the MFR;
- an accounting valuation, in accordance with accounting standards (now FRS17); and
- a valuation as laid down in the Finance Act 1986/Taxes Acts for the purpose of calculating the surplus.

An actuarial assessment of the 'surplus' or 'deficit' therefore depends on the method used. It will vary for any one scheme at any one time, according to the assumptions and valuation techniques used by the actuary. A scheme that is in surplus on one basis may not be on another.

## Tax treatment of surpluses

- 7.17. The Finance Act 1986 brought in a restriction on surpluses, introducing a statutory test for calculating the amount of past service surplus. This is calculated under a set of assumptions laid down by the Government Actuary (the 'prescribed basis'). The assumptions relate to both liabilities and assets. The amount of the statutory surplus is 105 per cent of the scheme's liabilities. If a defined benefit scheme (using the prescribed assumptions) runs a surplus of over five per cent, the Act requires it to take action to reduce the surplus to no more than five per cent, usually within five years.
- 7.18. If no action is taken, the scheme will lose part of its tax exemption. The trustees can recommend a contribution holiday, improve scheme benefits up to Inland Revenue limits, or pay the surplus to the employer, in which case it will be taxed at 40 per cent. Otherwise they must pay income tax on the income arising on the surplus. Valuations for this purpose must be sent to the Pensions Schemes Office at intervals of not more than three and a half years.
- 7.19. The 40 per cent tax rate was set in 1988 when corporation tax was 35 per cent. Three concerns lay behind the choice of rate:



- that companies might use the pension fund to hold profits tax-free, taking advantage of pre-announced or perhaps even anticipated changes in corporation tax;
- that a pension scheme with large surpluses could be at risk from asset stripping by a predator company following a take-over; and
- broadly to recover both the tax relief given for contributions to the pension scheme and also tax relief on the investment build-up within the scheme.

7.20 The issue has not been controversial because companies have not generally tried to have surplus repaid – but the tax rate is itself one of the reasons for not doing so.

## Sponsor access to surpluses

7.21. As a general principle, as far as true ‘balance of costs’ schemes are concerned, any disposable surplus disclosed by an actuarial valuation should automatically disappear through reduced employer contributions. In such schemes, the employer is only required to top up contributions made by employees, so while the scheme is in surplus, the employer does not have to make any contribution. However, as contribution holidays can take a long time to unwind surpluses, they are often not appropriate, especially in cases of corporate restructuring where the structure of pension provision may be changing. Where the rules of a scheme either fix the employer’s contribution or specify its level as not less than that contributed by the members, then provisions are needed to cover any surplus disclosed (without such provisions, a surplus might simply grow indefinitely).

## Disputes over the ownership of surplus

7.22. Until the 1980s, surpluses were rarely an issue. Four factors changed this:

- growth in the value of fund investments, coupled with reductions in workforces;
- concern on the part of the Government about perceived tax loss (Finance Act 1986);
- the offer of early retirement to scheme members, funded by surpluses; and
- the introduction of the SSAP 24 accounting standard in May 1988, which required the accounts of employers to spread pension costs over the expected remaining service lives of the current members in the scheme, and to reflect any prepayment as an asset in the fund.<sup>1</sup>

7.23. As a result, a number of different parties became interested in using the surplus for different purposes. The situation is complex. In a dispute over a scheme’s assets, at least four interest groups may be involved: the sponsor, active members, deferred pensioners, and pensioners. Their interests potentially all diverge. A brief summary of three critical cases in recent years illustrates the nature of such disputes.

7.24. In *British Coal Corporation v British Coal Staff Superannuation Scheme* [1993] 16 PBLR (15), the employer, British Coal, wished to enhance benefits so as to encourage the workforce to accept redundancies, using part of the pension fund surplus for this purpose. The court ruled against British Coal on the grounds that failure to make an agreed payment to cover specific expenses (that is, to pay additional contributions needed in respect of the benefits) amounted to a ‘cash withdrawal’, which the scheme rules forbade the employer from making for its own use.

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<sup>1</sup> SSAP24 has now been superseded by FRS17.

- 7.25. In *The National Grid Co plc and Others v Laws, Mayes and Others* [1999] 29 PBLR (16) (CA), the dispute began over whether the sponsors could decide unilaterally to offset contributions due against pension fund surpluses. But the central legal issue concerned whether the scheme's rules allowed employers to make any arrangements of their choosing. After the sponsor companies amended their scheme to enable them to do what they wished, a second hearing took place over whether these amendments were effective. The case went to the House of Lords over the question of whether outstanding contributions represent 'monies of the scheme'. (If they do, any amendment to cancel them would run counter to the provision in the rules prohibiting amendments having the effect of making 'monies of the scheme' payable to employers.) At the time of writing judgment is expected in April or May 2001.
- 7.26. In *Edge and Others v Pensions Ombudsman and Other* 3 WLR 79; [1998] 02 PBLR (29), the trustees amended the rules in accordance with their powers under the scheme. After considering the actuary's report and various options for reducing the surplus, they reduced the contributions made by employers and employee members in service. At the same time, they increased pension benefits to members in service but did not confer any benefits on pensioners. A pensioner then complained to the Ombudsman and the amendment was held to be invalid but that decision was later reversed by the High Court whose decision was upheld by the Court of Appeal.
- 7.27. The situation appears to be somewhat clearer following the recent judgment in *Barclays Bank v Holmes* [2000] 72 PBLR (30). The bank had sought to use the surplus in its defined benefit scheme to make contributions to the defined contribution scheme. The court ruled that a 'surplus is not in any way beneficially owned by any of the employees or pensioners under a scheme...it cannot be contended that a member of a pension scheme has any "right" ...to...surplus.'
- 7.28. However, the broader impact of this decision remains unclear, as it related to a specific instance – the use of the surplus to pay pensions. Disputes may still break out over the interpretation of individual provisions in trust rules, if perhaps not over the general principle of who owns the surplus.

## Conclusion

- 7.29. It has often been perceived that the interests of employers and scheme members diverge over the surplus. This is clearly true in a narrow sense: at any one time, more for one party to a particular fund clearly means less for the other.
- 7.30. But even for a single fund this may well not be true over the long term, and it is certainly not true across pension funds in general. Employers with a clear entitlement to part of the surplus are more likely to continue providing defined benefit schemes; and they are more likely to give those schemes the resources they need to be managed effectively.
- 7.31. The current situation therefore gives two grounds for concern. First, current taxation rates mean that while companies can benefit from surplus through contribution holidays, payment of any surplus to the employer is directly taxed at a higher rate (40 per cent). Yet in economic terms, there is little obvious difference between the two except for timing. Such a large differential in rates seems an unnecessary and unintended distortion.

**The review therefore recommends the tax rate on the withdrawal of surplus should be reduced, possibly to match the rate of corporation tax.**

7.32. Second, even where direct extraction of surplus might be considered, the sponsor may still face the possibility of extended litigation and uncertainty. This prospect serves nobody well. Its main effect is to weaken sponsors' interest in their schemes and to accelerate the move away from defined benefit provision. Greater certainty about access to at least a proportion of the surplus would help to maintain the viability of defined benefit schemes. It may be that no further clarification is possible here – and that some uncertainty is inevitable. But given the importance of the issue, this question should be thoroughly investigated.

**The review recommends that the Law Commission should be asked to review whether the objective of maximum clarity over ownership of the surplus can be achieved through legal change.**

## CHAPTER 8:

# Minimum Funding Requirement

## Background

- 8.1 The Minimum Funding Requirement (MFR) was created by the Pensions Act 1995. It is intended to provide protection for pensioners and other scheme members' rights by setting a benchmark for the acceptable level for a pension scheme's assets. It is designed to underpin the employer's commitment to support a defined benefit scheme it sponsors, so that in the event of the scheme having to cease, whether the employer is insolvent or not, scheme members already retired can expect their pensions to be paid in full, and scheme members who are not yet retired have 'a reasonable expectation' of receiving the value of their pension rights when they come to retire.
- 8.2 The current MFR test compares a scheme's assets and liabilities in a specified way, which is broadly as follows:
- the scheme's assets are valued at market levels;
  - the scheme's liabilities are divided between pensioners and those who have not yet retired and discounted to a capital value at different discount rates. For pensions in payment, the rate is the prevailing market yield on gilts.<sup>1</sup> For pension rights of scheme members not yet retired, the rate is broadly the assumed long-term rate of return for UK equities before retirement and for gilts after retirement, adjusted by a 'market value adjustment' factor to reflect prevailing UK equity dividend yields.
- 8.3 The MFR is an important issue for the review. Almost half the respondents to the consultation process commented on it, and over half of these viewed it as significantly affecting asset allocation decisions. It also has considerable wider significance. Providing security for members of defined benefit pension schemes is an essential objective for any responsibly run pensions system. While there is no reason to doubt that the overwhelming majority of pension funds are run both properly and effectively, it is essential to have effective safeguards to ensure that members of defined benefit pension schemes can have confidence in the system.
- 8.4 In considering the issue the review has therefore had twin objectives:
- a specific objective to ensure proper protection for members of defined benefit pension schemes; and
  - the remit of the review as a whole, to examine and seek to ameliorate distortions in investment decision-making.
- 8.5 The review's proposals were set out in an open letter to Ministers in November 2000 in response to a consultation exercise on the MFR by the Treasury and the Department of Social Security (DSS). This chapter sets out those proposals, together with some revisions to reflect comments and discussion following the initial proposal.

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<sup>1</sup> Although for large schemes, some of these liabilities can be discounted using an assumed long-term rate of return for UK equities.

## Issues raised by the current MFR

- 8.6 The MFR distorts investment decision-making by its use of a set of reference assets to calculate discount rates for liabilities: namely, UK quoted equities and gilts. Pension funds are not required to invest in these assets, but to do so is the best way of minimising volatility against the funding standard.
- 8.7 It is inherently difficult to quantify the extent of the distortion that a particular regulation has on investment decision-making, particularly since the first MFR valuations are only now taking place. But it is striking how frequently funds and their advisers spoke to the review of *matching the MFR portfolio*. This distortion is a cost. By preventing investment from being allocated in an optimal way, the MFR increases the cost of defined benefit pensions provision.
- 8.8 A number of respondents also felt strongly that the MFR was distorting the gilts market, with adverse consequences for capital allocation and economic efficiency, as well as an impact on annuity prices:
- 'It is now the case that the introduction of the MFR check has meant schemes, however well funded, are increasingly chasing the dwindling supply of gilts. In effect Government has changed the mindset of investment managers, advisers and trustees by legislation and the traditional split in favour of equities will be rebalanced towards fixed interest, possibly over quite a short period, with possibly adverse consequences for funding levels and surpluses.'*
- 'MFR encourages risk-averse strategies and discourages higher risk investments. It has, to an extent, distorted the market by driving schemes to invest more in gilts which are, partly in consequence, in short supply relative to demand.'*
- 8.9 The distortions and costs caused by the MFR might be justifiable if it delivered an important and necessary protection for members of pension funds. In reality, there are good reasons for believing that it does not:
- in the first place, any fixed standard such as the MFR is of only limited use. It simply records the state of the fund at one point in time, but financial markets and economic conditions change constantly. The fact that a fund has hit an annual target can create a misleading sense of security;
  - although the Maxwell affair was one of the strong impulses behind the creation of the MFR, it was not designed to protect against fraud; and
  - by distorting pension fund investment and so imposing direct costs on defined benefit pension funds, the MFR creates additional incentives for employers to close such schemes.
- 8.10 This latter point has wider ramifications. The MFR applies only to defined benefit pension schemes, not defined contribution schemes, because members of defined contribution and defined benefit schemes are subject to very different kinds of risk. Defined contribution members bear the investment risk of the contributions. Defined benefit members bear no risk at all unless the employer becomes insolvent; if this does occur, then they bear a mixture of investment risk and an additional 'trustee risk' – that the trustees could have incompetently or dishonestly managed the fund and left it underfunded.
- 8.11 There is already a series of provisions in pensions legislation and trust law to protect against trustee risk: the requirement for trustees to be independent, to take advice and so on. A number of these were introduced following Maxwell. It is not clear how significant is the

trustee risk remaining, given these provisions. This means that any measure to provide *further* protection for defined benefit members must consider carefully the costs involved, both for schemes and for the economy as a whole.

- 8.12 This is particularly important because of the specific impact that creating additional regulations like the MFR can have on pension provision, as set out in the chapter dealing with defined contribution pensions. Employers are not compelled to offer defined benefit schemes. If, because of regulation, the cost of such schemes becomes too high, they are likely to consider closing the scheme to new members. The scheme may even be wound up. The practical result is that future employees are deprived of access to defined benefit provision and have to join defined contribution schemes instead, effectively exchanging employer insolvency risk for investment risk. It is not clear that they are better protected as a result of this exchange.
- 8.13 Most fundamentally, it seems that a funding standard such as the MFR, by its nature, does not address properly the question of protecting defined benefit scheme members. The MFR is concerned to prevent a situation where a defined benefit pension fund is insufficiently funded and then, because of employer insolvency, is unable to meet its obligations. Yet to determine whether such a situation is likely to arise requires one to take a view of what the future investment returns of the fund will be. Whether or not the pension fund will in practice be able to pay its pensions will depend on future investment returns. A true system of protection for beneficiaries should focus on the issue of the reasonableness of that assumed return.
- 8.14 This the MFR fails to do. Rather, it seeks to establish whether a pension fund is 'underfunded' or not using assumptions which are:
- the same for all funds, albeit with adjustment factors for maturity;
  - fixed by legislation; and
  - treated as a technical question, for resolution by the actuarial profession.
- 8.15 None of these points is justified. The assumptions should differ with the maturity of the scheme, the strength of its sponsor, and the views of the trustees on a suitable investment strategy. They should be free to change with changing circumstances. They are not an obscure technical question, but the very heart of the question of whether the fund is adequately funded or not.
- 8.16 It follows that the MFR does not provide the protection that many assume it does, as the standard assumptions it makes may prove to be wrong. Indeed, its effects could well be counterproductive to the extent that it gives trustees a spurious sense of certainty about funding levels and weakens the fiduciary responsibility that should be at the heart of protection for members of defined benefit schemes.

## **An alternative to the MFR**

### ***Criteria***

- 8.17 An MFR replacement must provide effective protection for members of defined benefit pension schemes by seeking to protect against clearly inappropriate investment strategies, but not against all possible economic scenarios. The latter would be so costly as to make continuing provision of defined benefit pensions impossible. Equally, while the review is concerned to remove unnecessary distortions to investment decision-making, if a funding standard has no effect at all on investment decision-making, then it is either ineffective or

not needed. A criterion must therefore be that an MFR replacement only affects the investment of funds which are pursuing an investment and funding strategy which is inappropriately risky given the nature of the fund's assets and liabilities and the attitude and strength of its sponsor company.

8.18 An MFR replacement might also take account of the important differences between small and large schemes:

- larger pension funds control the bulk of pension fund investments. Precise figures are not available, but it appears that more than 80 per cent of pension fund money is controlled by the top 400 or so schemes. They also contain the majority of defined benefit pension scheme members: schemes with more than 4,000 members account for approximately 70 per cent of the total community of private sector defined benefit scheme members. They typically have greater levels of management resources to devote to managing the schemes, and third-party interest in their activities would generally be greater;
- conversely, small schemes have fewer management resources than large schemes, so solutions which would work well for large schemes might prove burdensome or unrealistic for them.

8.19 The options have therefore been assessed against the following criteria:

- that any alternative should seek to provide effective protection for members of defined benefit schemes by preventing funds from taking an inappropriately risky attitude to investment given the circumstances of the fund and its sponsor; and
- that the differences between small and large funds should be taken into account.

8.20 More generally, an MFR replacement will be most effective where it encourages pension fund decision-making which is:

- skilled;
- transparent;
- well-informed; and
- properly debated.

### ***Improved protection against fraud***

8.21 An important impetus for the creation of the MFR was the Maxwell affair. That was a case of fraud, yet the MFR was not in fact designed to tackle fraud. Pension fund fraud has been relatively rare, but its impact on individuals in these rare cases can be significant, and the review therefore made two initial proposals in the open letter to Ministers of November 2000 which could help protect members of defined benefit pension schemes against the risks and consequences of fraud. Neither involves imposing unnecessary or excessive costs.

8.22 Where a fraud has taken place, the Pension Compensation Scheme (under revised proposals contained in the Welfare Reform and Pensions Act 1999 and due to come into effect shortly) is limited to restoring a fund to either:

- 100 per cent of its pensioner liabilities on an MFR basis (and those within 10 years of retirement) and 90 per cent of its MFR liabilities for other members; or
- the amount of the loss, whichever is the lesser (since otherwise underfunded schemes which were subject to fraud would benefit relative to equally underfunded schemes which were not).

8.23 This is funded by an industry levy scheme supervised by the Pensions Compensation Board.

**The review recommends that the level of this compensation for non-pensioner members be increased to cover not simply the 90 per cent of MFR liabilities as at present, but something closer to the cost of securing members' accrued rights (or the amount of the loss, whichever is the lesser).**

8.24 The precise formula for calculating the accrued rights would be for further discussion.<sup>2</sup>

8.25 This would provide additional protection in the event of fraud, without burdening the industry with excessive costs.

8.26 The review also believes that the question of custody of pension fund assets should be looked at again. Although the great majority of schemes use custodians independent of the employer, not all do. Protection for pension scheme members from the risk of fraud could be improved by making custody independent of the employer a mandatory requirement for pension funds. This would make it more difficult for improper use to be made of a pension fund's assets.<sup>3</sup> This would be reinforced by trustees taking appropriate steps to ensure that the fund's control environment was fit for purpose.

**The review recommends that there should be a statutory requirement for funds to have independent custody.<sup>4</sup>**

### ***A proposed alternative***

8.27 The present MFR and all funding and solvency standards focus attention on the wrong question: whether, given certain investment assumptions and methods of calculating liabilities, the value of a defined benefit pension fund's assets exceeds the value of its liabilities at a given date. This is, however, not the same question as that which interests beneficiaries: namely, whether at some point in the future their pensions will be paid. The present value of the liabilities is not the same as the eventual cost of meeting them, since that will in practice depend on future investment returns of the fund and the investment strategy of the fund, which in turn depends on its maturity, the strength and risk appetite of the sponsoring employer and the views of the trustees. In its calculations, the present MFR has the effect of assuming that a fund is backing pensioner liabilities with gilts and non-pensioner liabilities with UK equities, which is clearly a very specific assumption that will not and should not necessarily apply to every fund.

### **Solvency test**

It has been argued by some that there is a clear and objective measure of underfunding: the extent to which the scheme has sufficient funds to secure benefits by purchasing annuities for pensioners and deferred annuities for non-pensioners. This is certainly objective, and trustees may well find it helpful to consider the extent to which their scheme is funded on a solvency basis, in the context of a wider discussion of investment strategy. But this is quite different from making the solvency standard the basis of a statutory requirement which must be met. It is far stricter than the present MFR, and the purpose of the consultation on the MFR was not to increase strictness further.

Moreover, it is equivalent to making unrealistic assumptions about investment strategy. If a fund were wound up, it is far from certain that trustees would seek to secure benefits by

<sup>2</sup> On a separate but related issue, some adjustment would also need to be made to the regime governing transfer values, where the MFR currently serves as a statutory minimum. This is a matter for future consideration from both the actuarial and public policy perspectives.

<sup>3</sup> One of the objections in the past to this idea was that custodians are not regulated, but they now are.

<sup>4</sup> The Government should consider whether this should also apply to local authority pension funds, which are exempt from the MFR.



buying annuities. Deferred annuities in particular are expensive. In many cases, it might make more sense either to run the fund on as a going concern or to seek a transfer value for non-pensioners into another pensions vehicle. In either case future investment returns would strongly affect the actual pension paid. So the fact that a fund did not meet a solvency standard of this sort would not necessarily mean that future pensions were in fact under threat. To impose this as a requirement, or even to give pension scheme members the impression that this was the correct yardstick against which funding should be judged by publicising it to them, would be wrong. This is particularly true in view of the emotive and misleading associations of the term 'insolvent' for the average scheme member. Insolvent companies rapidly close down – indeed, it is an offence for the directors of an insolvent company to allow it to trade. The term does not have the same meaning in the pensions context.

- 8.28 The key proposal of the review with regard to the MFR is therefore that instead of a calculation of fund solvency levels based on uniform assumptions and a requirement to meet some level of solvency according to this particular calculation, members should be protected by *scrutiny of whether the future investment returns required to meet liabilities in future are reasonable*.
- 8.29 The key issue for pensioner protection is the judgement of assumed investment returns. Any centrally set funding or solvency standard errs in standardising this judgement. The review believes that the right approach to protecting defined benefit scheme members is to expose the views that the fund has taken on future investment returns and make them the key focus of discussion. If the critical issue for the level of funding is the reasonableness and appropriateness of investment assumptions, then the best protection for pension scheme members is to ensure that these assumptions are as robust and well thought-through as possible.
- 8.30 The review's consultation document raised the possibility of broadening the field of debate on investment decisions. A number of respondents argued that this was inappropriate, as poor investment performance by a defined benefit fund only affected the sponsoring employer and not the beneficiaries, as their pensions were guaranteed. This is generally true – but not where one is seeking to provide protection from the consequences of employer insolvency, as is the case here. It is the members' interests which are at stake. Subjecting investment assumptions to outside scrutiny and comment would make it more difficult for a fund to proceed on the basis of inappropriate assumptions. It would reinforce and clarify the trustees' fiduciary responsibility to have an appropriate and well thought-through investment strategy. The better the trustees fulfil this responsibility, the better the protection for defined benefit scheme members.

**The review therefore proposes that each defined benefit pension fund should be required each year to set out in clear and straightforward language such matters as:**

- **the current value of its assets and in what asset classes they were invested;**
- **the assumptions used to determine its liabilities;**
- **planned future contributions;**
- **its planned asset allocation for the following year or years;**
- **the assumed returns and assumed volatilities of those returns for each asset class sufficient to meet the liabilities;**

- **a justification by the trustees of the reasonableness of both their asset allocation and the investment returns assumed in the light of the circumstances of the fund and of the sponsor; and**
- **an explanation of the implications of the volatility of the investment values for possible underfunding, and a justification by trustees of why this level of volatility is judged to be acceptable.**

8.31 This information would be produced, as part of the statement proposed by the review in Chapter 11, annually. More detailed information on the state of the fund, including a statement of the solvency of the fund on immediate wind-up<sup>5</sup>, would be available to beneficiaries on request.

8.32 Pension funds are already required to produce a report and accounts, and Statement of Investment Principles. An annual Statement of Investment Principles could be drafted in such a way as to answer the questions above. But as explained in Chapter 2, the Statement does not need to do so, and most do not. A combined document, along the lines above, is therefore required.

8.33 The process of having to prepare the transparency statement would enable trustees to think carefully about whether their investment strategy is sound. Making it publicly available would expose it to outside scrutiny, which should be encouraged. There are a number of bodies which might exercise this scrutiny:

- individual beneficiaries and their advisers;
- trades unions, where there are active members that are union members;
- pensioner support groups;
- the media, particularly the personal finance media;
- competitors of the advisers to the trustees;
- the credit rating agencies, and creditors of the sponsor company; and
- sponsor company shareholders and capital market analysts.

8.34 Pension funds would be required to distribute the transparency statement to beneficiaries and to lodge it with Opra, who would make it publicly available through the internet.

### **Comments on the review's proposals**

8.35 A range of organisations commented on the review's proposals in their own published responses to the Government's consultation exercise on the MFR. Many echoed the review's criticisms of the MFR.

*'The potential long-term damage to pension provision in the UK should not be underestimated. In 20 or so years' time, there are likely to be many more employees in the UK with inadequate pensions as a direct consequence of the MFR than there would have been without it.'* (NAPF)

*'the MFR has distorted investment decision-making and does not provide real protection for members of defined benefit occupational pension schemes.'* (Engineering Employers' Federation).

8.36 Many, among them both the NAPF and the CBI, also supported the review's approach of replacing the MFR with a system based on transparency. A number who did so expressed

<sup>5</sup> A figure which requires careful interpretation (see box, p.118).

doubts about the specific suggestion that members should be able to vote for an independent report (see box). Many of the same responses made their own suggestions for alternatives to an independent report to provide underpinning for a regime of transparency and disclosure, such as a statutory duty of care for the actuary or the construction of a scheme-specific funding standard based on the fund's own plans, as the NAPF have proposed.

- 8.37 A number of respondents also made some detailed comments on the format of the review's proposed transparency statement, suggesting an alternative which they referred to as the Statement of Funding Principles.
- 8.38 Others suggested instead that the MFR be replaced by another standardised test, but one which applied only to some portion of the benefits, such as those accrued to date.
- 8.39 The essential principles of the review's proposals for protecting members of defined benefit schemes from underfunded pension funds are set out above: that there should be a long-term, scheme-specific approach based on transparency and disclosure with no centrally dictated set of reference assets distorting investment decisions.
- 8.40 For that reason, the review does not agree with proposals for a standardised test which applied only to some portion of the benefits. This would still create artificial incentives to match the assets (in this case, usually corporate bonds) used to generate the discount rate for the liabilities. If pension fund trustees choose to invest in bonds because they believe that this class of assets offers the best chance of meeting liabilities cost-effectively and at an acceptable level of risk, then that is their decision. But policy should not create artificial incentives for them to do so because of the way funding standards are designed.
- 8.41 However, the review believes that other respondents' detailed suggestions, which go with the grain of the review's proposals, have merit, and should be considered by the Government.

### Independent report

The review proposed that provided some minimum percentage by number of the members voted in favour, trustees could be required to commission an independent report on their funding and investment policy by an appropriate expert, paid for by the fund. This would provide a second opinion on whether the trustees had set out an appropriate and thought-through strategy, given the circumstances of the fund, the employer and so on, and would be made available to all members. What precisely the minimum percentage should be was left for discussion. The letter to Ministers argued that if it were much above 10 per cent of the beneficiaries it could be difficult for beneficiary concerns to be raised effectively, and if it were much below 5 per cent there would be a risk that a small number of beneficiaries with another agenda could disrupt the running of the pension fund without justification.

One might also provide that a similar number of beneficiaries could also trigger a Members' Meeting of the fund, at which trustees would have to explain their thinking, though again that would be for discussion.

Failure to act on the report would trigger involvement from Opra, who would have the ultimate sanction of its powers to disqualify trustees. As a further protective measure, Opra would also have its own power to require the fund to commission an independent report.

## ***Assessment of preferred option against criteria***

8.42 The review's proposal meets the criteria set out above and fulfils the objectives of providing effective protection for members of defined benefit pension schemes while minimising investment distortions. Funds would have to make clear both their current financial position and their future plans, which would reveal if they are planning to pursue inappropriately risky strategies. They would not be able to pursue these policies in the face of clear opposition from beneficiaries and other interested parties. But at the same time, if strategies were appropriate for the fund and its particular circumstances, then trustees would be free to pursue them without distortion. This approach would encourage investment decision-making which is well-informed, skilful and properly debated.

## **Other options**

### ***Insurance***

8.43 The review considered and rejected some other options as replacements for the MFR.

8.44 Some preliminary discussions took place with major participants in the reinsurance markets about the possibility of insurance replacing the MFR. The conclusion was as follows.

8.45 Effectively, defined benefit pension funds would be buying insurance against the insolvency of the sponsoring employer. In the event of employer insolvency the insurer would have to make up a proportion of any shortfall that emerged between the value of the pension fund's assets and their liabilities. They would not take on the long-term liability to pay pensions; rather, they would pay out a single sum based on independent actuarial valuation of the value of members' pension entitlement. It would then be for the trustees of the fund to decide whether to wind up the fund or to continue it on an ongoing basis.

8.46 This insurance would effectively be credit insurance against the possibility of the employer becoming insolvent. The state of the fund would determine the size of the payout. The major issues for such insurance would be:

- whether it could be provided practicably; and
- who would provide it.

8.47 Various markets in credit insurance already exist. The major hurdles would be, as for any insurance product, adverse selection and moral hazard. Adverse selection could in principle be dealt with by making insurance compulsory. A defined benefit fund that was not able to get insurance would have to wind up.

8.48 Moral hazard covers a wider range of issues. There are some specific areas of concern such as small director-only schemes. The primary moral hazard is the concern that the existence of insurance would lead to funds undertaking reckless investment policy safe in the knowledge that pensions would be covered. It is important to bear in mind that this would generally arise only where the pension fund was already underfunded to such a degree that meeting its obligations would bankrupt the company. In such a situation, it would be rational for the company and for the trustees to want the pension fund to be invested in high-risk, high-return assets.

8.49 There could be two mechanisms for mitigating moral hazard:

- insurance would not be 100 per cent. This is normal with insurance arrangements and compensation schemes in financial services;

- the insurer would use risk-based pricing, raising the premium if the fund's investment policy was felt to be too risky, on the grounds that this increased the size of the possible payout.
- 8.50 These measures would mitigate moral hazard, though they could not remove it.
- 8.51 The simplest method for supplying this type of insurance would be from the commercial markets. Investigations suggest that in principle these risks can be priced and that a market could exist in them - indeed, such a market already exists through credit derivatives and credit insurance. However, discussions have also confirmed that the willingness of insurance markets to take on risk can and does change over time. One could not rely on the markets to provide sufficient cover at all times – and it is precisely when such cover would most be needed, at times of economic difficulty, that it might not be available.
- 8.52 This means that insurance could only provide reliable ongoing protection if there were also a mutual insurer for defined benefit pension funds, to ensure that there was always a source of insurance. Creating such an insurer would be a complex task. It would have to have effective risk-based pricing in order to control moral hazard. This in turn would be difficult if there were not a strong alternative available from commercial insurers to provide market discipline. The aggregate cover offered by the mutual would need to be capped in some way, as it could not provide cover against a major and sustained collapse in the value of assets in the world economy.
- 8.53 As made clear above, preliminary investigations suggest that it would be possible to create such a system, subject to further work on the details. However, the investigations also suggest that it has some very significant disadvantages.
- 8.54 Most importantly, it would represent an additional cost for providers of defined benefit schemes – at times, possibly a considerable one – and as such would create additional incentives for employers to move away from such schemes. This is not an effective way of meeting the objective of protecting members of defined benefit pension schemes.
- 8.55 There are also good grounds for thinking that it could, in practice, prove as distortionary towards investment as the current MFR. Insurers might very well impose some sort of funding standard themselves. Even if they did not, since the insurer would be scrutinising funds at regular intervals and altering premiums to reflect the current risk – that is to say, the current level of funding – it would be much more difficult for pension funds to take a long-term view, as any short-term investment underperformance would be likely to lead to a rise in their premium. Given the review's remit to investigate distortions in investment decision-making, this is a serious additional disadvantage.
- 8.56 The review therefore did not recommend insurance as a way forward.

### ***The proposal of the Faculty and Institute of Actuaries<sup>6</sup>***

- 8.57 As the DSS/Treasury consultation document acknowledged, the Faculty and Institute of Actuaries was asked to answer a tightly-defined and specific question in its review of the MFR. It is therefore no criticism of the work that they did to say that it still shares the same problem as other funding/solvency standard approaches. It imposes standard assumptions on investment returns to determine whether a fund is either side of a line in the sand at a

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<sup>6</sup> Pensions Board of the Faculty and Institute of Actuaries, 'Review of the Minimum Funding Requirement: A Report to the Secretary of State for Social Security,' May 2000.

particular moment in time. This could be distortionary and affords neither consistent nor effective protection. The specific proposal to move to a bond-based discount rate does not address these wider concerns. As was said above, if pension fund trustees choose to shift their fund's assets more into bonds because they believe that this class of assets offers the best chance of meeting liabilities cost-effectively, then that is their decision. Policy should not create artificial incentives for them to do so through a funding standard.

### **FRS17**

A number of respondents raised the issue of accounting standards FRS17 in the context of the MFR. Under this standard, defined benefit pension fund assets are marked-to-market and liabilities are valued using an AA corporate bond yield as a discount rate. The net value of the fund is then reported in the balance sheet at the end of each year. A gain or loss resulting from changes to assumptions or differences between expected returns and outcomes is recorded in the Statement of Total Recognised Gains & Losses, but not the profit and loss account.

Respondents expressed concern that, even if the MFR were replaced, FRS17 could cause similar distortions, as pension funds would have an incentive to invest in the relevant corporate bonds in order to minimise fluctuations in their balance sheet, rather as the MFR creates incentives to invest in UK equities and gilts.

This is in principle correct, and the review believes that it would have been better to have shown the information required in FRS17 in notes to the accounts, rather than on the balance sheet itself. At the same time, the incentive effects of the MFR and FRS17 are not directly comparable. There is a statutory requirement to meet the MFR funding level, whereas FRS17 is simply a requirement to report against a particular standard. Moreover, the fact that it does so in a way which does not feed directly through to the profit and loss account will also somewhat weaken the effect.

Clearly the impact of FRS17 on pension fund investment decisions will need to be monitored, and if it were found to be having strong distorting effects, the review believes that it would be right to revisit the issue.

### **Regulation**

- 8.58 The DSS/Treasury consultation paper raised the possibility of a regulator being used to protect pensions through a system of more active prudential regulation. In many ways, this is a variant of the review's proposal, where the fund's strategy and assumptions are subjected to external scrutiny. But the review believes it to be a variant which is undesirable.
- 8.59 The issues here are ones where judgements will differ from person to person, which means that there should be the maximum of debate in the widest possible arena about them. Giving responsibility for this assessment to a regulator with significant power places a great reliance on the judgement of the individuals employed by the regulator. Some may very well have excellent judgement, possibly better than the beneficiaries of the fund and other interested parties. But others will not, and there will inevitably be a general tendency to take a bureaucratic and overcautious approach. This itself will make running defined benefit schemes more burdensome and costly, accelerating the move away from defined benefit provision. Nor indeed is there any guarantee that the result will always be better protection for members of defined benefit schemes. Regulators can underestimate risk as well as overestimate it.
- 8.60 The review therefore recommends that the Government does not pursue regulation as a solution.

## **A Central Discontinuance Fund**

8.61 This option has been promoted by some. It would involve schemes with insolvent employers being combined into a central fund which instead of having to buy out its liabilities or seek transfer values to other schemes, could run on, investing in a broader range of securities. This involves a continuing risk of underfunding. It could therefore take one of three forms:

- a fund with a guarantee from the industry. This, it seems to the review, is effectively a less transparent and effective method of mutual insurance, since it introduces an intermediary body, the central discontinuance fund, between the source of the risk (the funds) and the insurer (the rest of the industry). This would seem to raise the problems of insurance, particularly moral hazard, in a more stark form;
- a fund with a guarantee from the Government. This in the review's view could not be defended. Effectively, taxpayers, increasing numbers of whom are members of defined contribution schemes, would be underwriting the pensions of members of defined benefit schemes. This would be inequitable;
- a fund with no guarantee. It is unclear what benefit this would bring, except insofar as it might allow small funds to continue as self-standing entities rather than buying out their liabilities from a life insurance company or transferring to another scheme, and therefore to secure higher returns. If this is a benefit, then it suggests that there is a problem with securing a fair transfer value of pensions when schemes wind up, which is a separate problem to the one which an MFR replacement is seeking to address, and it should accordingly be tackled separately.

### **Proposed Directive on the Prudential Regulation of Occupational Pensions**

The review notes with some concern that the directive on the prudential regulation of occupational pensions proposed by the European Commission proposes a funding requirement, which could replicate many of the faults of the MFR, as set out above. In particular, funds would need to determine their 'technical provisions' – an actuarial calculation of accrued rights and pensions currently in payment – and either ensure that they have 'appropriate assets' to cover them, or adopt a plan to make up any underfunding by this measure.

There is no certainty that the directive will be agreed in its present form. Indeed, the review believes it is important that it should not be. A proposal of this kind, if implemented, would risk recreating very much the kinds of distortion in investment behaviour which the review's recommendations on the MFR aim to eliminate. To value the liabilities of a fund according to a particular interest rate (determined by national rules), and then to insist that the fund hold assets to match those liabilities, is fundamentally misguided as an attempt at pensioner protection. Like the MFR, it would risk harming pensioners by causing their pensions to be invested in a suboptimal way without actually providing improved protection.

**The review recommends that the Government continues to take a close interest in the current European discussions on pension provision. The Government should make the case in Europe that such standardised requirements are flawed and counterproductive, and are not in the best interests of pensioners.**

## **Conclusions and recommendations**

8.62 The review concludes that the MFR is distorting investment patterns without providing effective protection for members of defined benefit pension schemes. By making calculations

based on standard assumptions it can give a misleading picture of the level of security of pensions. It is distorting investment choices. It is increasing the cost of defined benefit provision and thereby creating artificial incentives to move to defined contribution. Indeed, its effects may actually be counterproductive to the extent that it gives trustees a spurious sense of certainty about funding levels, weakening the sense of fiduciary responsibility.

**The review recommends that the MFR should be replaced by a scheme-specific long-term approach based on transparency and disclosure, under which pension funds would report publicly on the current financial state of the fund and on future funding plans.**

- 8.63 This would make clear where funds' ability to pay future pensions was based on reckless or unsuitable assumptions about investment returns, level of contribution, life expectancy and so on. The precise nature of secondary controls that should exist within this framework is a matter for Government.



## CHAPTER 9:

# Life Insurance

## Introduction

9.1 Life insurers are responsible for a large part of the UK's savings and investment markets. The total amount of wealth invested in life insurance products has grown from £276 billion in 1989 to £977 billion in 1999.<sup>1</sup> Life offices own over 20 per cent of all UK equities on behalf of individual investors and pension schemes.<sup>2</sup> This emphasises the importance of the life insurance industry to the economy as well as to individual savers and investors.

9.2 The chapter:

- describes the industry's main products;
- evaluates the impact of regulation on investment decision-making;
- considers the nature and focus of competition, focusing in particular on with-profits funds, and the extent to which this drives investment decision-making; and
- draws conclusions about further work required in this area.

## Origins of life insurance involvement in investment

9.3 The main focus of the life insurance industry is on savings and investment products. Although the savings element is not a strict requirement of life insurance, it is the promise of investment returns that tends to attract funds. The investor often views life cover as a secondary incentive. There are a number of reasons for this:

- life insurance shares with savings and investment a common theme of providing for the future by the regular payment of small sums of money;
- in the past, life policies offered policyholders significant tax advantages;<sup>3</sup>
- the with-profits policy, the traditional form of life insurance investment, offers both diversification and some protection from market downturns, which it is argued provides reassurance for consumers nervous of equity markets; and
- from the life office's perspective, the need to manage a large pool of premiums over long periods of time leads naturally to involvement in investment issues.

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<sup>1</sup> Association of British Insurers (ABI) *Insurance Statistics Yearbook*, 1989-99.

<sup>2</sup> Association of British Insurers *Insurance Statistics Yearbook*, 1989-99.

<sup>3</sup> Some arguably remain, provided a policy is a 'qualifying policy' (in essence, a regular premium policy that has either been held for at least 10 years or is a whole-of-life policy). In this case, the proceeds of the policy will not usually constitute a taxable gain for the purposes of Capital Gains Tax (CGT). However, life funds themselves pay tax on their investments within the fund.

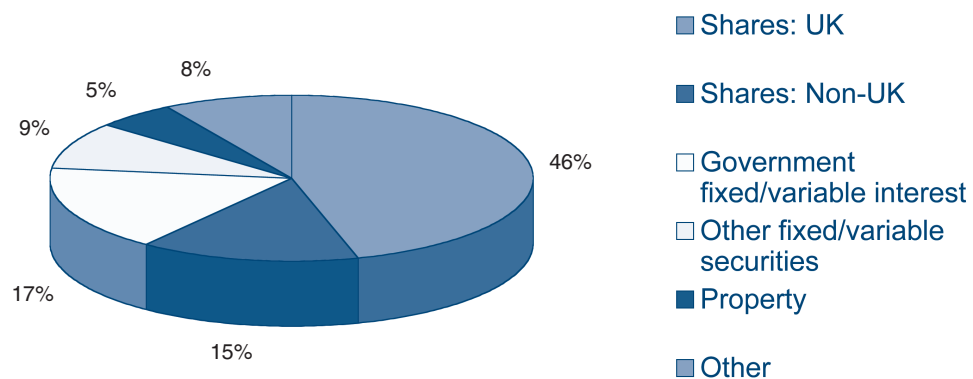
9.4 Table 9.1 shows life companies' premium income in 1999, and the market share of the top 25 companies. Figure 9.1 then shows how life companies invest their assets. In 1999, equities accounted for nearly half (46 per cent) of life insurance investment holdings.

**Table 9.1: Life companies' premium income 1999<sup>4</sup>**

Rank	Name of group	Single premiums £ billions	Regular premiums £ billions	Total £ billions	Market share
1	Legal & General	15.6	1.2	16.8	15.4%
2	Barclays	12.5	0.4	12.9	11.8%
3	Prudential	6.8	2.7	9.5	8.7%
4	Standard Life	2.7	2.5	5.2	4.8%
5	AXA	3.0	1.2	4.2	3.9%
6	CGU	2.8	1.0	3.8	3.5%
7	Norwich Union	2.5	1.3	3.8	3.5%
8	Equitable Life	2.0	1.6	3.5	3.2%
9	Friends Provident	2.2	1.2	3.4	3.1%
10	Halifax	2.7	0.6	3.4	3.1%
11	Zurich	1.7	1.6	3.2	3.0%
12	Abbey National	2.4	0.4	2.9	2.6%
13	AEGON	2.1	0.7	2.8	2.5%
14	AIG	2.5	0.1	2.5	2.3%
15	Scottish Widows	1.6	0.9	2.5	2.3%
16	UBS	2.2	0.0	2.2	2.0%
17	Royal & SunAlliance	1.1	0.9	2.1	1.9%
18	Lloyds TSB	0.8	1.2	2.0	1.8%
19	Nat West	1.5	0.2	1.7	1.5%
20	CIS	0.6	0.8	1.4	1.3%
21	AMP	0.8	0.6	1.4	1.2%
22	NPI	0.8	0.3	1.1	1.0%
23	Liberty International	1.1	0.0	1.1	1.0%
24	Skandia	0.7	0.2	1.0	0.9%
25	Scottish Life	0.5	0.3	0.8	0.8%
	Rest of industry	7.0	6.8	13.8	12.6%
	<b>Industry Total</b>	<b>80.3</b>	<b>28.7</b>	<b>109.0</b>	

Source: Government Actuary's Department – Form 47 of insurance company returns for the period 1/4/99 to 31/3/00

**Figure 9.1: Life Insurance Investment holdings**



Source: Government Actuary's Department – figures drawn from insurance company returns for the period 1 April 1999 to 31 March 2000 and from the ABI's Insurance Statistics Yearbook 1989-99

<sup>4</sup> The figures have been taken directly from statutory returns and reflect the ways in which each company chooses to classify its premium income.

## Types of investment products offered

9.5 Life offices offer four broad categories of product:

- term assurance;
- savings and investment;
- pensions; and
- annuities.

9.6 Term assurance is essentially a pure insurance product and is therefore not covered by the review. Annuities have also not been considered in detail by the review (see separate box). Savings products, pensions and some annuities in turn can take one of two forms<sup>5</sup>:

- linked; or
- non-linked (for example, with-profits).

### **Linked investments**

9.7 Linked investments are so-called because the amount invested is linked directly to the investment performance of permitted assets or permitted indices. As their name suggests, index-linked investments are linked to the performance of a specific index, for example the FTSE 100. Property-linked investments are linked to fluctuations in value of some described property or class of property that can include shares, other securities and property. UK domestic legislation derived from European Community Directives sets out the characteristics an asset must have in order to constitute a permitted link. The most significant, for the purposes of this review, is that any securities must be readily realisable, regardless of whether they are listed or unlisted.<sup>6</sup>

9.8 Individuals who invest in a linked fund have their investments pooled together with those of other investors. The fund will invest in defined areas. Insurers normally offer a range of funds; these may include a balanced managed fund,<sup>7</sup> typically invested in a mixture of equities, bonds and cash; UK equity funds; various overseas equity funds; and so on. It is up to the individual to decide in which fund or combination of funds to invest. The return on the investment depends on the performance of the underlying assets within the fund or funds selected and on the underlying management charges and sales expenses.

9.9 With linked products, the end-customer essentially makes the asset allocation decision. As such, only the stock selection decision can properly be described as institutional.

9.10 The key issue driving institutional decision-making in this area is the choice of a target benchmark, whether peer group or index. These have already been discussed in Chapter 3 on pension fund decision-making, and many of the same issues apply.

9.11 The retail nature of these products raises another series of issues. These concern:

- the level and nature of product charges;
- the information available to individuals making their choices; and
- the quality of advice available to individuals.

These are consumer issues, outside the direct remit of this review. A proposal for taking this work further is set out at the end of the chapter.

<sup>5</sup> Thus pensions and endowment policies can be written as either linked or with-profits, for example.

<sup>6</sup> See paragraph 9.28 and following.

<sup>7</sup> The Association of Unit Trusts and Investment Funds defines a balanced managed fund as having at least three asset classes, with no more than 85 per cent equity exposure and at least 10 per cent of the fund in non-UK equities.

## Annuities

The most common form of annuity is the compulsory purchase annuity. This is the investment a policyholder buys with a lump-sum pension fund, intended to give the policyholder a regular income in retirement. It is currently mandatory for the fund accumulated under a pension to be used to buy an annuity before a person's 75th birthday. Life insurers use actuarial assumptions to estimate the stream of income they will need to meet their liabilities under these annuities. Life offices can then invest in assets designed to meet the timing of those cash flows. This will typically be in bonds and government securities. The other form of annuity is usually called a purchased-life annuity. Unrelated to pensions, this is simply a mechanism for converting a lump sum into an income stream.

The nature of annuity business means that there is little scope for flexibility in its investment patterns. As a standard annuity represents an absolute commitment by the insurance company to pay a certain sum of money for an indefinite period, this liability must effectively be covered by gilts or highly-rated bonds. In recent years, more innovative products such as with-profits annuities and linked annuities have become increasingly popular. The practical effect is to split the annuity into two portions: one a standard annuity, while the other participates in some other type of investment. This diversity is a positive development but these new products may not be appropriate for all. The immediate problem is, and is likely to remain, to enable people to build up a sufficient fund of money to provide a decent income in retirement.

The decline in gilt yields is also having a marked effect on the returns available to annuitants. This is a consequence of the greater maturity of pension funds leading to increased portfolio commitment to fixed income securities combined with a lack of gilt issuance, exacerbated by the incentive effects of the Minimum Funding Requirement.

Considerable debate surrounds the issue of compulsory annuitisation. This is an important issue, but it is one that connects with wider pensions policy issues that extend beyond this review's remit.

## ***Non-linked investments***

- 9.12 For the purposes of this review, the most significant feature of non-linked investments is with-profits investment and the associated free assets. Here there is no immediate or direct link between the investment performance of any particular group of assets and the return to investors. Policyholders not only share in a 'smoothed' version of the returns on the with-profits fund; they also share in the profits (or losses) of the life insurer. Individuals' with-profits investments are pooled together with the life insurer's own funds and invested in a wide range of asset classes.
- 9.13 In conventional with-profits policies, instead of receiving investment growth based on the performance of the pooled funds as in linked investments, the individual receives an annual discretionary bonus (called the reversionary bonus because once awarded, it is added to the individual's share of the pooled investment fund and cannot be retracted by the life office) and a discretionary terminal bonus payable at the end of the policy term. In unitised with-profits contracts, funds are invested in units, either in the with-profits fund or in linked funds or in a mix of both. Here the bonuses normally take the form of revised valuations of the unit prices.

## Unitised with-profits

An increasing volume of with-profits business is now in the form of unitised with-profits policies. These allow individuals to follow the progress of their participation in the with-profits fund by multiplying the number of units they own in the fund by the price of each unit as calculated by the life company. In this case, reversionary bonuses take the form of percentage increases to the price of units.

One of the drivers behind this shift to unitised with-profits policies was the potential advantage with regard to regulatory requirements for reserving. Their design meant that they reduced the need for life offices to reserve funds against the full value of the potential life insurance liability from the start of the policy. Reserving for potential liabilities was therefore less onerous in the case of unitised with-profits policies than with conventional with-profits policies. However, the Insurance Company Regulations were amended in May 2000<sup>8</sup> to remove this advantage.

At first glance, unitised with-profits policies may appear to offer greater transparency. However, the mechanisms by which each unit is priced and by which bonus levels are set are ultimately no more transparent than those used for traditional with-profits policies.

- 9.14 Table 9.2 below shows the main participants in the with-profits market. Market share has been calculated on the basis of the 'new business index' which is an industry standard measure incorporating both regular and single premium life and general annuity business. The table shows a relatively high degree of concentration in the industry with the ten largest providers in 1999 accounting for over 70 per cent of the market. This may intensify in future years through a continuing trend towards mergers and acquisitions.
- 9.15 The objective of a with-profits policy is to provide a less volatile return than a linked fund. In good years, some of the investment returns are held back through the smoothing mechanism to boost returns in the bad years. For the individual investor, the advantage of the with-profits contract is that it allows investment in a wider range of asset classes than such a person might otherwise have considered. Risk is reduced through diversification, without requiring any further decisions from the individual investor.
- 9.16 The investor also shares in any profits or losses made by the life office, hence the use of the phrase 'with-profits'. Such a fund is intended to provide relatively stable returns over time because the use of annual bonuses based on the fund's performance smoothes out the peaks and troughs of investment performance. Any differences between the annual bonuses and an appropriate share of the fund's assets should be wrapped up in the terminal bonus when the policy matures. But the extent to which individual investors receive their full asset share by means of these bonuses is not transparent.

<sup>8</sup> Insurance Company Regulations 1994 as amended by The Insurance Companies (Amendment) Regulations 2000.

9.17 The individual investor or saver in a with-profits fund will generally only be aware of the amount they have contributed and the reversionary bonuses that are awarded annually. Beyond the initial sales literature, investors are not always kept informed about:

- the performance of the fund that has generated their bonuses;
- how the level of bonuses relates to the performance of the fund;
- how the fund is invested; and
- what the level of terminal bonus is likely to be.

**Table 9.2: New unitised and conventional with-profits premiums 1999**

Rank	Name of group	NBI <sup>9</sup> £ million	Market share (based on NBI)
1	Prudential	362	19%
2	Friends Provident	162	8%
3	Abbey National	143	8%
4	Halifax	114	6%
5	Norwich Union	109	6%
6	AXA	100	5%
7	Standard Life	98	5%
8	Scottish Widows	96	5%
9	Royal & Sun Alliance	86	5%
10	Equitable Life	82	4%
11	Legal & General	76	4%
12	CIS	68	4%
13	AMP	62	3%
14	AEGON	37	2%
15	Zurich	32	2%
16	Scottish Provident	32	2%
17	NFU	30	2%
18	Britannic	30	2%
19	CGU	26	1%
20	NPI	26	1%
21	Police Mutual	18	1%
22	United Assurance	12	1%
23	Royal London	12	1%
24	Scottish Friendly	11	1%
25	Sun Life	11	1%
	Rest of industry	70	4%
	<b>Industry Total</b>	<b>1,905</b>	<b>100%</b>

Source: Government Actuary's Department – form 47 of insurance company returns over the period 1 April 1999 to 31 March 2000

<sup>9</sup> NBI – New Business Index – calculated on the basis of 10 per cent of single premiums plus 100 per cent of regular premiums.

## Surrender values

A further important feature of with-profits policies is that a person who is unable or unwilling to continue making payments into a policy and who surrenders it before the full term is unlikely to receive their full asset share. Figures from the Personal Investment Authority (PIA) show that for regular premium policies taken out in 1994, by the end of year four over 30 per cent of policies sold by company representatives had been surrendered, as had nearly 25 per cent of policies sold by Independent Financial Advisers (IFAs). This pattern of lapse is consistent with rates for previous years. This is particularly relevant in the context of with-profits endowment policies written to support a mortgage, mostly over a 25-year term. It has not proved possible to establish the percentage of endowments held by their original purchaser to maturity, not least because the bulk of these were written in the 1980s and will not mature until some time after 2010. Nevertheless, given the PIA data, it seems likely that only a minority of original purchasers will hold these policies to maturity.

The earlier a policy is surrendered, the greater its probable loss in value relative to the premiums paid. This results from the high initial cost of writing a policy, of which commission to the salesman selling the product appears typically to form a significant part. However, many surrenders fail to achieve even the value of the premiums paid. Given the charging structure and up-front commission associated with endowments, figures from *Money Management* magazine suggest that actual surrender values for the average endowment will show a negative yield on surrender after two, five and seven years. Only after ten years do average yields show a positive return, and even then not in all cases.<sup>10</sup>

To some extent, selling the policy on the rapidly growing second-hand market for endowment policies can mitigate the effective penalty for early surrender. But many companies do not make their policyholders aware of this option. Effectively, there are market-makers in traded endowments who believe they can make a profit on buying an endowment from the policyholder at more than its surrender value, then selling it on to a new investor who will hold it to maturity and who will then generate a further profit. This is a practical demonstration of the relatively low returns on surrendered policies paid by many life offices.

9.18 The analysis now considers two sets of incentives acting on life insurance companies:

- regulation; and
- the nature of competition.

## Regulation

9.19 Most of the relevant regulations originate in the various European Life Industry Directives produced from 1979 to 1992. These are implemented through domestic legislation, principally the Insurance Company Regulations 1994, and in guidance from the regulator, the Financial Services Authority (FSA).

9.20 The main driver of investment regulation is consumer protection and the general requirement for a margin of solvency – that assets should exceed liabilities by a suitable margin. Such a provision requires the regulations to state how both assets and liabilities should be valued and determined. In practice, implementing the requirement for a solvency margin divides into three separate sets of rules:

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<sup>10</sup> *Money Management* January 2001 survey: endowment mortgages – actual surrender values as at 1 October 2000.

- valuation rules: these use prudent assumptions to ensure that assets are not over-valued;
- admissibility rules: these reduce the values obtained before they are included in a solvency margin calculation; and
- determination of liabilities: these make sure, among other things, that liabilities are discounted at an appropriate rate of interest.

9.21 The regulations then set out a series of separate requirements, in addition to the basic solvency test and associated regulations, including:

- counterparty rules, to limit credit risk;
- rules relating to liquidity of assets; and
- currency matching rules.

9.22 Certain regulations apply to both linked and non-linked insurance products, others to only one of them.

### ***Solvency ratio***

9.23 Section 32 of the Insurance Companies Act 1982 requires all companies to maintain a minimum margin of solvency. This margin represents the excess of the value of a company's assets over its liabilities, each element being determined in accordance with the applicable regulations.

### ***Admissibility rules***

9.24 The admissibility rules limit the extent to which certain classes of assets can be counted in the solvency margin. Only assets for which a valuation rule exists are admissible. The overarching requirement is to maintain assets of adequate diversity and spread – for example, there is a five per cent limit on holdings in any one authorised unit trust, a one per cent limit on investments in securities and beneficial interests in limited partnerships from any one issuer, and a 10 per cent limit on the aggregate of such limited partnership investments.<sup>11</sup>

9.25 In the past, these limits have been put forward as a possible barrier to investment in private equity. Discussions with individual life offices did not generally support this view. Life offices rarely have holdings of sufficient size to come close to triggering the relevant restraints. This reflects the fact that the admissibility limits are by no means the only spur to prudence on the part of insurance companies.

9.26 But as limited partnerships are also becoming an increasingly popular vehicle for property investment, this restriction may start to bite by effectively imposing a ceiling of 10 per cent on an insurer's combined holdings of property and private equity. Should this occur, it would seem an unintended consequence of the regulation. As one respondent said:

*'The overall limit under the Insurance Companies Regulations of 10% for unlisted and unsecured investments would in due course need to be raised to 20% if the desire for increased venture capital allocations and deeper debt capital markets, along the lines seen in the US, is to be achieved.'*

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<sup>11</sup> Insurance Companies Regulations 1994, Schedule 12.



**The review therefore recommends that the practical effects of the 10 per cent ceiling on investment in limited partnerships should be kept under review by the FSA.**

### ***Asset valuation rules and the readily realisable rule***

9.27 The main rules for valuing assets are set out in the Insurance Company Regulations 1994 and apply to all products, both linked and non-linked. The general approach uses market values. One requirement is that assets must be adequately diversified and spread to avoid excessive reliance on any particular category of asset, investment market or investment. Two particular issues were identified by the review.

9.28 The first is the valuation of investments in limited partnerships. Regulation 51 of the Insurance Company Regulations 1994 states that the value of a limited partnership should be the value which 'ordinary prudent investors would place on the asset in a non-forced purchase or sale'. Further interpretation states that Regulation 51 does not provide an option to give a lower valuation than the rules propose: 'the company should assign a value in accordance with UK GAAP...' and '...have regard to the valuation guidelines given by the British Venture Capital Association document, *Guidelines for the Valuation and Disclosure of Venture Capital Portfolios*, or obtain an independent quotation from an investment firm.'<sup>12</sup>

9.29 This approach seems reasonable.<sup>13</sup>

9.30 The second issue relating to asset valuation rules is that of the 'readily realisable test'. There is a specific requirement for linked products that the property to which they may be linked must be 'readily realisable'. This means that they must be available and able to be sold within seven working days for an amount not less than 97.5 per cent of their market value. The reason given for this is that policyholders in unit-linked funds can 'cash in' their units at any time, so the fund must maintain adequate liquidity. It is also, however, a restriction on investment options.

9.31 A number of respondents argued that the regulations discriminate against assets that do not have a clear market value, potentially affecting investment performance. As one succinctly put it:

*'If an investment fails the "readily realisable" test ... it cannot be used to back property-linked benefits ... This test will always discriminate against venture capital, which will always fail the test.'*

9.32 This would seem to discriminate against illiquid assets, such as investments in limited partnerships. However, the FSA has told the review that it would consider providing a statutory concession to an insurer to allow the use of securities such as venture capital stocks that were not readily realisable, particularly if they were used within the context of a collective investment fund where:

- the fund's liquidity was satisfactory; and
- there was a reasonable basis for pricing units within the fund.

9.33 Life offices clearly perceive the readily realisable rule as a barrier to private equity investment.

**The review recommends that the FSA should publicise its willingness to consider concessions from the readily realisable rule.**

<sup>12</sup> Prudential Guidance Note 1995/1.

<sup>13</sup> The issue is often confused, however, with the impact of private equity investments on the valuation of *liabilities*. This is considered overleaf.

## **Liability valuation rules**

9.34 The EC Directive prescribes that the discount rate for liabilities should be set at 'a prudent rate of interest' and 'under no circumstances may the rate of interest used be higher than the yield on assets ... less an appropriate deduction.'<sup>14</sup> The Insurance Company Regulations as currently framed then specify the yield on assets as being the dividend yield.

9.35 Several respondents argued that the current reliance on a yield-based discount rate makes high-yielding assets artificially attractive:

*'Valuation guidelines focus on yield which results in a high degree of matching to high yielding assets, which may not always be the most appropriate long-term investment strategy.'*

*'Generally, with-profit companies with relatively low free assets are forced into holding a high level of fixed interest securities because they have a relatively high yield compared to equities. While this may improve the security of the fund it may not be in the best interest of the policyholder as, all other things being equal, their final payouts may be worse.'*

9.36 This is only partially true. The FSA is currently consulting on a modification to these rules that would allow the yield to reflect an element of current earnings as well as the dividend. This should mitigate the bias towards one particular type of asset.

9.37 But the regulatory approach does raise wider issues. For conventional with-profits business, the regulations require that income (dividends and interest) should be used either to discount liabilities or to declare reversionary bonuses. Capital appreciation is then used to pay the terminal bonus. In other words, income-generating assets lead to high reversionary bonuses and, by reducing the value of liabilities, a higher Free Asset Ratio (see paragraphs 9.56 to 9.59). Assets with capital growth enable high terminal bonuses to be paid. This means that the regulations create a close link between a fund's investment decisions and the company's marketing strategy.

9.38 It is not clear whether consumer interests are always best served by this approach. This is part of a wider discussion considered at the end of this chapter.

## **Counterparty rules**

9.39 These limit the extent of permitted exposure to any one counterparty:

- 5 per cent to any one individual;
- 10 per cent to any one approved credit institution, and so on.

9.40 The review is not aware of particular concerns relating to these.

## **Currency matching rules**

9.41 The Third Life Co-ordination Directive<sup>15</sup> requires that when a significant portion of liabilities are in any given currency, then at least 80 per cent of the corresponding assets must be denominated in the same currency. Although this requirement does not apply to free assets

<sup>14</sup> First Life Directive 79/267/EEC, Article 17.

<sup>15</sup> Council Directive 92/96/EEC, Annex I, 4.

(since they are, by definition, assets held *in excess* of those needed to meet liabilities) in practice it influences investment decision-making. Life offices tend not to hedge their overseas investments, regarding currency as one element in the overall management of risk and reward.

- 9.42 The wording of the new *Prudential Sourcebook*<sup>16</sup> is likely to change to clarify the currency matching rules. Under the proposed new wording it is made clear that for funds invested overseas (for example, a linked policy invested in Japanese securities valued in Yen) currency matching will mean that at least 80 per cent of the liabilities should be denominated in Japanese Yen. When a policy matures or is liquidated and the proceeds have to be paid out in Sterling, then the currency will have to be converted. However, funds do not have to be 80 per cent in Sterling all the time. This is a helpful development.

### ***Tax administration***

- 9.43 A number of life company respondents raised the taxation of investment in limited partnerships as a regulatory issue. The issue is discussed in Chapter 12 on private equity.

### **Competition**

- 9.44 Life insurance products (with the exception of pooled pensions) are retail products. In principle, therefore, competition to offer retail customers superior investment performance should be the primary driver of investment decision-making. In practice, however, several factors work against this.

### ***Consumer understanding***

- 9.45 It is generally accepted that the population as a whole has a poor understanding of investment and savings issues. As a consequence, people do not plan adequately for their financial future. This in itself makes effective competition on investment performance difficult.
- 9.46 It might be thought that the use of IFAs would compensate for this lack of consumer understanding. IFAs play an extremely important part in the sales process, giving advice on products and product providers. They account for most individual single premium sales and nearly 40 per cent of individual regular premium business. (Direct sales forces and tied agents are the other significant sources of business.)<sup>17</sup>
- 9.47 IFAs are usually rewarded by commissions paid by the life offices. Alternatively, they may charge their clients a fee or operate on a mix of fees and commission. Commission levels vary between life offices and within individual product ranges. Offering higher commission than competitors is viewed in the industry as an important factor in generating increased sales. Differing commission levels on different types of product can and do have a material impact on sales. The review has been told that many products that appear very similar to others from a financial planning perspective attract considerably higher sales as a direct consequence of paying higher commissions.
- 9.48 This casts doubt over how competition operates in the industry from the consumer's perspective. These doubts are particularly strong in the case of with-profits policies.

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<sup>16</sup> *The Prudential Sourcebook*, which forms part of the FSA's Handbook of rules and guidance under the Financial Services and Markets Act 2000, sets out required prudential standards for regulated firms.

<sup>17</sup> Source: Association of British Insurers.

## **Competition in with-profits business**

- 9.49 The nature of the with-profits fund has a significant impact on the type of competition in this market. Insurance companies do not compete on the basis of the investment performance of the underlying fund but rather, on the level of reversionary and terminal bonuses paid to customers. It might appear that there would be a relatively straightforward correspondence between the two, as those life insurance offices with the highest risk-adjusted returns would be able to pay the highest bonuses.
- 9.50 This is not the case in practice. First, the cost of surrender part-way through a policy means that competition is heavily focused on the point of sale, when investors are deciding which policy to buy. If returns to investors later prove unsatisfactory, closing the policy is very unlikely to be a cost-effective option for them.
- 9.51 In making the decision to recommend one policy over another at that crucial point, IFAs often concentrate on the historic returns achieved by their supplier compared with competitors. Yet historic investment performance is generally a poor guide to future performance. This is even more true for with-profits policies than for more direct investments because of the smoothing of returns associated with the with-profits concept, and the indirect relationship between investment returns on life funds and returns on individual with-profits policies.
- 9.52 Moreover, life offices do not generally give customers information on life fund investment returns. As one respondent put it:

*'Although life offices presumably measure the investment performance of their with-profits funds, the results are not made public.'*

- 9.53 The with-profits fund may include substantial profits from conventional insurance business unrelated to investment. Part of the investment return may also be based on the performance of assets not directly attributable to policyholders. Moreover, whatever the investment performance of the assets in the fund, it is the life office itself, under actuarial advice, that decides the extent to which performance is reflected in the level of bonuses paid:

*'For with-profit funds the most readily available public data is over the long term, comparing the current payouts on policies now maturing. It is clearly in an insurance company's competitive interest to be perceived near the top of these league tables. This in itself is reliant on the rate at which the actuary is prepared to release surplus on a basis which he views as equitable.'*

- 9.54 For example, a company might increase its level of reversionary bonuses over a period of years by utilising its reserves. This could be funded either by improved performance of the underlying assets or by reducing the planned size of the terminal bonus, or a combination of the two. In the long term, the two methods obviously have very different outcomes for customers but the figures for returns considered by the IFA would show improved short-term returns in both cases. And as the underlying investment performance of the fund is not reported, the long-term consequences would remain hidden. Alternatively, a fund might pay high terminal bonuses in a year when relatively few policies are maturing, which it would not be able to maintain in later years. This would again generate high returns to customers in the short term, which would not be sustained.

- 9.55 So competition is focusing on a measure that does not necessarily reflect – indeed usually does not reflect – actual investment performance. Yet there are no clear rules setting out how annual and terminal bonuses should be calculated, or what factors should be taken into account. The liability profile of the fund, and hence of the claims on the free assets, adds a further complication, as the fund’s liability profile can change significantly after the decision to buy, depending on the volume and type of business subsequently written. Again, consumers are often unaware of this process and can anyway do nothing about it.
- 9.56 In an attempt to circumvent this problem and better understand the true financial position of life funds, financial advisers and consumers sometimes look at a company’s Free Asset Ratio (FAR). Free assets are those assets not earmarked for any specific known liability. The FAR at its simplest looks at the ratio of surplus long-term assets (that is, long-term admissible assets less total liabilities) to total liabilities. IFAs seek to use the FAR as a measure of:
- the financial strength of a life office, and its ability to make future bonus payments;
  - the extent to which the fund has capital on which to draw for the ‘smoothing’ of annual bonuses in with-profits policies; and
  - the possible size of the terminal bonus.
- 9.57 As a result, many life offices also seek to compete on the basis of a high FAR. But the FAR is a regulatory calculation. The assumptions it makes to value assets and liabilities were devised by regulators, for regulatory purposes. Whatever its merits for regulation, the FAR’s use as an indicator of investment flexibility gives it a much greater and wider impact than originally intended by those who framed it. Moreover, it has been put to the review that the FAR is a fairly crude measure. For example, if liabilities are reinsured, removing them and their linked assets from the calculation, the absolute size of the free assets remains the same, but because the liabilities and the assets covering them have been reduced, the free asset *ratio* increases.
- 9.58 In addition, although future profits on existing policies are given a nil value for regulatory purposes (and hence for calculating the FAR), they can be ‘sold’ by the life insurer through reinsurance and/or securitisation. This has the effect of boosting the life office’s reported regulatory capital and hence the FAR without changing the underlying liabilities. In a more sophisticated assessment of a life office’s financial strength, investors or intermediaries should take into account the extent to which different insurers are reporting comparable figures. Since with linked products the value of liabilities varies directly with the value of the underlying assets, it is important to take into account only those assets and liabilities that are relevant to with-profits policies when looking at financial strength.
- 9.59 In other words, competition in life insurance is based on proxies that relate only poorly at best to investment performance. This is not to imply that life companies do not compete fiercely. They do. But they compete on these various proxy measures and ones related to them – for example, the level of the ‘guaranteed bonus’ for the first year of a policy. They do not compete on the underlying investment performance of the fund.
- 9.60 From the perspective of a review of distortions to investment decision-making, it is a matter of concern that competitive pressures in the industry are not primarily oriented around investment performance. This is an issue which needs to be tackled.

## Policyholders' reasonable expectations

A number of respondents argued that the opacity of the with-profits fund was partly the result of legal constraints arising from the concept of 'policyholders' reasonable expectations'. According to this view, greater transparency about the performance of the with-profits fund in any given year would give policyholders a 'reasonable expectation' that they would receive whatever return was reported in that year. This would then become a liability, which the insurer would need to cover with a lower-risk, lower-return asset, thus depressing the return on the fund in the long run.

These concerns appear misplaced. As far as potential customers are concerned, disclosure does not create any greater expectation of a certain return than the current practice of selling policies on the basis of the level of bonuses paid in the past. As far as existing customers are concerned, simply adding the normal caveat that investments are not guaranteed should be sufficient to allay any fears that policyholders will expect a certain return. Indeed, greater transparency designed to reveal how a fund's performance varied from year to year would arguably lead to more realistic expectations on the part of consumers than the practice of informing consumers only about the level of bonuses. As one respondent put it:

*'The major issue for policyholders' reasonable expectations is the potential for confusion between headline bonus rates and underlying reality.'*

## Conclusions and recommendations

- 9.61 The review believes that a number of regulatory changes could usefully be made. These are:
- **that the FSA should keep the practical effects of the 10 per cent ceiling on investment in limited partnerships under review;**
  - **that the FSA should publicise its willingness to consider concessions from the readily realisable rule; and**
  - **that changes be made to the method of taxation of life company investment in limited partnerships.<sup>18</sup>**
- 9.62 The review also believes that principles of effective investment decision-making, similar to those set out in Chapter 11, should apply to life insurers as well as to pension funds. Life funds should be able to give their customers much better information about issues such as the fund's overall investment objective and its achieved investment returns.
- 9.63 However, as competition drives decision-making, the issue of investment decision-making cannot be considered separately from the broader issues highlighted above.
- 9.64 The evidence suggests that several factors are distorting competition, particularly in with-profits business:
- the end-consumer's lack of understanding of the issues;
  - financial incentives to advisers and sellers, mostly through the commission system, which are unrelated to investment performance; and
  - a focus for competition in the with-profits business on factors such as historic bonus levels and the FAR which are only loosely related to investment performance.

<sup>18</sup> This is discussed in Chapter 12.

9.65 Yet tackling these issues effectively would take the present review far beyond its already broad remit.

**The review therefore recommends that the Government should initiate a separate independent review of capital and information flows around personal investment products.**

9.66 The review would cover the range of personal investment products available to the small investor. Its focus would be on equity investments including life insurance, unit trusts and investment trusts as well as pensions investment vehicles designed for individuals.

9.67 It would examine issues such as:

- the drivers underlying competition;
- information flows to consumers, and consumers' understanding of them;
- the nature and quality of consumer advice;
- advisers' incentives and skills;
- charging structures for products; and
- the principles of governance within the relevant products.

9.68 It would of course be essential for the review to take account of other work in this area: notably the FSA's review of with-profits business announced in January of this year, and the insurance industry's Raising Standards initiative.

**In addition, the review recommends that the further review should consider how to apply to these products the investment principles proposed in Chapter 11.**

## CHAPTER 10:

# Pooled Investment Vehicles

### Introduction

- 10.1 Pooled investment vehicles – a third, somewhat smaller category of institutional investment – are used both by individuals and by other institutions. For individuals, they offer a means of investing in a diversified portfolio managed by professional investors. For smaller institutions, segregated management of their investment portfolio may not be cost-effective, and pooled investment vehicles offer an alternative. Larger institutions, even where most of their portfolio is managed on a segregated basis, may also use pooled investment vehicles to acquire an exposure to a particular sector, where investing that segment of their portfolio on its own would not be cost- or risk-effective.
- 10.2 Pooled investment vehicles fall into three main groups:
- unit trusts;
  - open-ended investment companies (oeics); and
  - investment trusts.
- 10.3 Unit trusts are collective investment schemes constituted under the terms of a trust deed. While essentially the same in economic terms, oeics have a different legal structure, taking a corporate rather than a trust form. Both are open-ended, which means they can expand or contract to meet demand for units/shares.
- 10.4 Investment trusts are closed-ended investment vehicles that take the legal form of a company. They have fixed issued share capital<sup>1</sup> and are traded on the Stock Exchange.
- 10.5 A further important distinction is that of authorisation/regulation. Unit trusts can be authorised unit trusts, which are regulated by the Financial Services Authority, or unauthorised unit trusts<sup>2</sup>:
- authorised unit trust schemes may be promoted to the public, and as such are subject to regulation under the Financial Services (Regulated Schemes) Regulations 1991;
  - unauthorised unit trusts, which are not covered by this regulation, may not be promoted to the public<sup>3</sup>. They are mainly used as vehicles for institutional investment and may benefit from special tax treatment from the Inland Revenue.
- 10.6 Investment trusts are not regulated. They are listed companies subject to company law and listing requirements. They are authorised by the Inland Revenue for tax purposes.
- 10.7 It should also be noted that, although life funds are not considered to be pooled investment vehicles and are covered by an entirely different regulatory regime, from the point of view of the retail customer, the two are often indistinguishable and can compete directly.

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<sup>1</sup> Although investment trusts have fixed issued capital, like all companies, they are able to issue more shares and buy-back their own shares for cancellation (under certain circumstances).

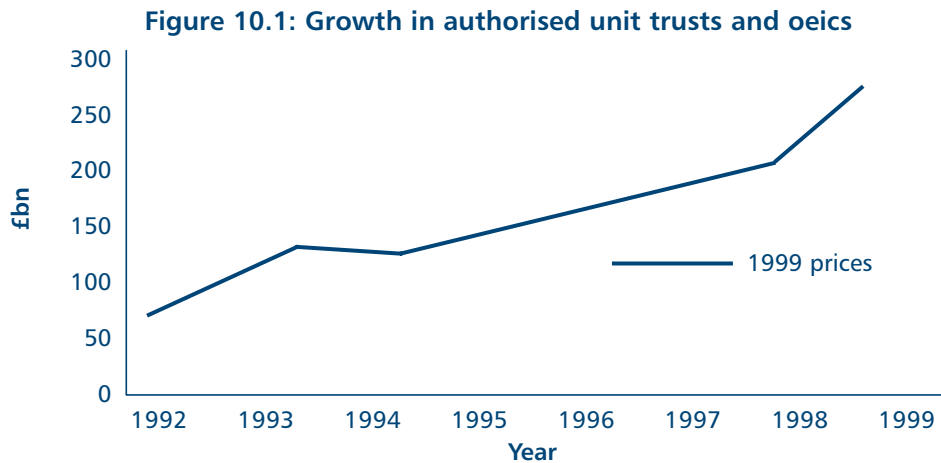
<sup>2</sup> Oeics are not permitted to exist in an unauthorised form in the UK.

<sup>3</sup> Except to the extent permitted under the Financial Services (Promotion of Unregulated Schemes) Regulation 1991, which allows their sale to high net worth individuals under certain circumstances.

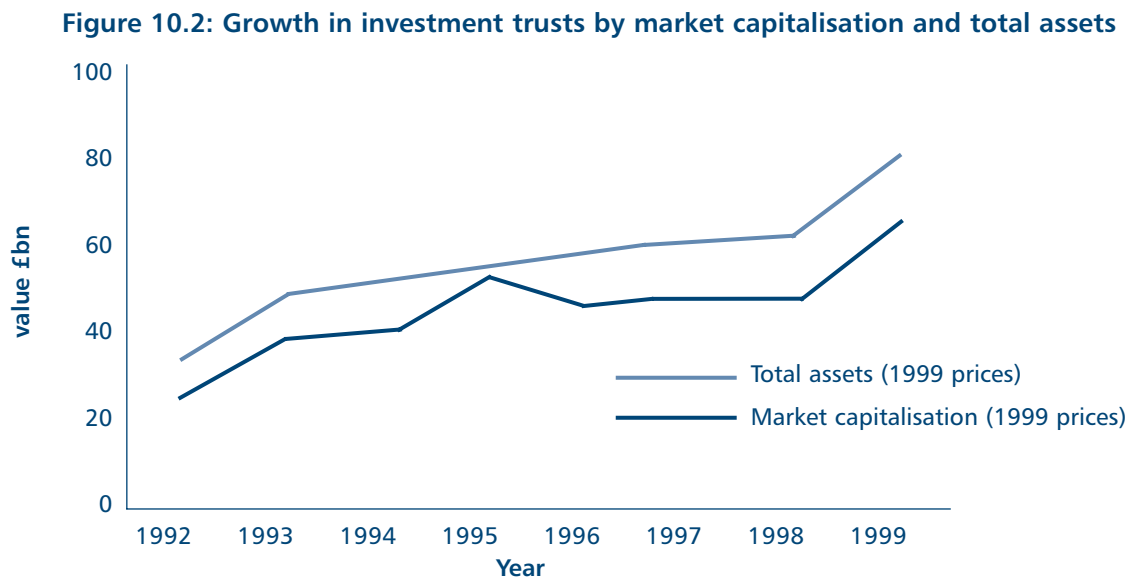


## Size and composition of the markets

10.8 Unit trusts, investment trusts and 'other financial institutions'<sup>4</sup> owned 9.7 per cent of the UK stock market in 1999<sup>5</sup>. Figures 10.1 and 10.2 show growth in funds managed in authorised unit trusts/oeics and growth in the value of investment trusts.



Source: Association of Unit Trusts and Investment Funds (AUTIF).



Source: Association of Investment Trust Companies (AITC).

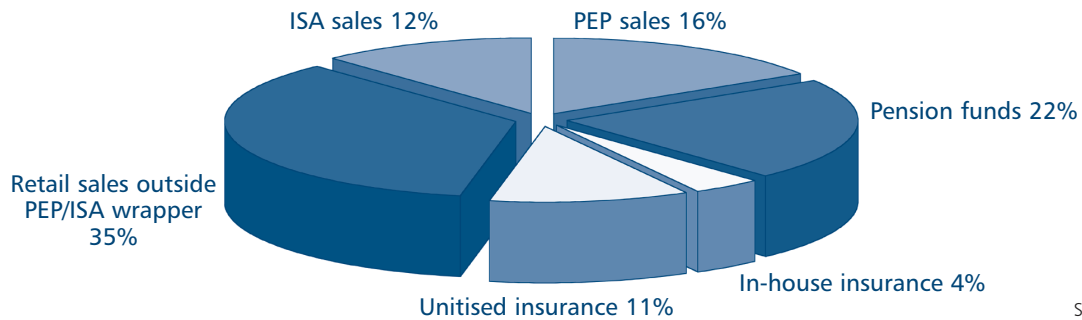
10.9 It has been estimated that institutions account for two-thirds of the investment in investment trusts. Respondents suggested that as much as 40 per cent of funds managed in authorised unit trusts and oeics were owned by institutional investors.

10.10 Figure 10.3 gives a breakdown of sales of authorised unit trusts/oeics in 1999. It suggests that institutional investors accounted for 37 per cent of gross sales.

<sup>4</sup> This category is largely unauthorised unit trusts.

<sup>5</sup> ONS, *Share Ownership, a report on the Ownership of Shares at 31st December 1999*.

Figure 10.3: Authorised unit trusts and oaic gross sales 1999



Source: AUTIF.

## Pooled pension funds

As set out in Chapter 2, pooled funds are often used as a lower-cost alternative to segregated management of a pension fund. Funds using the pooled approach can either delegate the asset allocation decision to the pooled fund provider, buying the provider’s balanced or mixed fund; or they can set their own asset allocation by buying selected specialist funds invested solely in specific asset classes.

Estimates suggest that institutional investors have invested approximately £200 billion in pooled funds in the UK.<sup>6</sup> This represents approximately 25 per cent of total pension funds under management and is made up mainly of small to medium-sized defined benefit schemes and defined contribution schemes. Pooled funds are the preferred investment form for defined contribution schemes.

Pooled pension fund managers have developed a number of different structures. Pooled pensions are unitised by nature: this is a prerequisite for a pooled vehicle in which each investor must know how much of the pool is theirs. This produces two main investment routes – the unit trust/oaic or the unit-linked life fund. Historically, life insurance companies set up pooled pensions as managed funds or unit-linked life funds as their client’s portfolios reached a size that no longer called for a fully insured scheme. Fund managers, on the other hand, who traditionally handled segregated funds and came from a unit and investment trust background, tended to set up exempt unauthorised unit trusts or authorised unit trusts for their pooled pension funds.

As segregated funds, pooled funds have historically tended to use a peer group benchmark, although in line with the growing use of specialist funds, index benchmarks are now increasingly common. The issues raised by benchmarking were considered in Chapters 3 and 5.

## Investment decision-making by pooled investment schemes

- 10.11 Many issues raised in the rest of the review are also relevant to pooled investment vehicles where these are sold to institutional investors: for example, the general question of benchmarking, the skills and competence of the purchaser and so on.
- 10.12 In considering sales of pooled investment vehicles to *retail* investors, however, the central question for the review is the extent to which competition between providers is focused on investment performance. If competition is indeed on investment performance, then the competitive process should in principle drive efficient capital allocation.

<sup>6</sup> Source: CAPS.

10.13 One particular area of concern is costs. The costs of pooled investment vehicles are critical in determining investment performance, particularly in an environment of low nominal investment returns. There are a number of reasons for doubting that competitive forces work effectively to drive maximum efficiency in this area:

- research shows that most retail investors do not understand fully the impact of costs on return, much less terms such as 'reduction in yield' (RIY) that are used to calculate the costs of pooled investment vehicles;<sup>7</sup>
- A Personal Investment Authority study in 1999 of RIY showed a very wide range of RIY from 0.6 per cent to as high as 3.4 per year. The average active RIY in that study was 2 per cent per year;<sup>8</sup> and
- the review was told that the practice of charging certain costs (marketing costs, for example) direct to the fund rather than disclosing them as costs to the retail investor is growing among oeics. This risks distorting competition by giving certain costs a higher profile than others.

10.14 A further concern surrounds the incentives acting on advisers. As with life insurance, the practice of product providers paying Independent Financial Advisers through commissions of varying levels for the sale of products with comparable investment features also raises concerns over the extent to which competition is genuinely focused on investment performance.

10.15 Investigating such issues would take the review beyond its already broad remit into a range of issues that belong essentially to the retail market.

**The review therefore recommends that the proposed review of personal investment products should include within its remit the market for unit trusts/oeics and investment trusts. The review also recommends that the further review should consider how to apply to these products the investment principles proposed in Chapter 11.**

10.16 Although investment trusts do not share the cost structure and other characteristics of unit trusts and oeics, the increased promotion of investment trusts to retail investors, both directly and through wrappers, warrants their inclusion.

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<sup>7</sup> 'surveys of investor knowledge in both the UK and US consistently find that retail investors do not understand how disclosed charges affect performance, let alone the pound and pence cost of that performance impact.' Kevin James *The Price of Retail Investing in the UK* (FSA Occasional Paper), 2000, p6.

<sup>8</sup> 1999 *Disclosure Report*, Personal Investment Authority, March 2000

## Investment in private equity by pooled investment vehicles

Under Regulation 5.09 of the Financial Services (Regulated Schemes) Regulations 1991, a securities fund may invest up to 10 per cent of the fund in 'unapproved securities' – effectively, unquoted securities. A number of responses cited the 10 per cent rule as a possible inhibitor of investment by unit trusts into private equity. But the review is not aware of any authorised pooled vehicle that invests in private equity to any significant degree at all, much less up to the 10 per cent limit. It therefore does not appear likely that this regulation presents a real obstacle to further investment into private equity or more ambitious investment strategies by unit trusts and oeics.

The true obstacle is more likely to be the underlying need for liquidity: investment in illiquid assets is extremely difficult for vehicles that need to be priced regularly to admit new investors and allow existing investors to redeem in a manner equitable to both groups and continuing investors.

By contrast, investment trusts do not face the same pricing or liquidity issues affecting authorised unit trusts and oeics. This makes it much easier for them to invest in illiquid asset classes such as private equity. At the same time, growth in the investment trust sector has lagged behind that of the unit trust sector. The main problem associated with investment trusts appears to be that, except in a few sectors, their shares tend to trade at a discount to the net asset value of the underlying securities, thereby deterring investors and frustrating the raising of new capital or the promotion of new trusts.

This is to be regretted. The investment trust sector has been characterised by a high degree of innovation. While closed-end vehicles undoubtedly raise some issues, they offer a means for investors for whom liquidity is an issue (notably defined contribution pension funds) to invest in otherwise illiquid asset classes. It is to be hoped that the revival of interest in investment trusts in recent years will continue, and that institutions will use their special features to invest in asset classes that they would otherwise find difficult to access. The steps individual trusts are taking to acquire and cancel their own shares at a discount to net asset value is making a helpful contribution to achieving a balance between market supply and market demand that clears closer to net asset value.<sup>9</sup> It reduces the risk of the discount and serves to highlight the opportunity to purchase a portfolio of securities at below market value.

<sup>9</sup> Since April 1999, no Advance Corporation Tax (ACT) is payable on a share buy-back and this tax cost has disappeared. Many investment trusts had previously stated that they did not plan to buy back shares until ACT was abolished.

## CHAPTER 11:

# Principles

- 11.1 In the preceding chapters of this report, the review began to develop a blueprint for more effective institutional investment decision-making.
- 11.2 One way of ensuring that the reality of institutional investment more closely approximated this blueprint would be for the Government to compel institutions to behave in certain ways, through regulation. However, regulation cannot easily accommodate the diverse nature of the institutions whose investment behaviour is examined in this report.
- 11.3 This is one reason why the review has recommended a solution to the distortion caused by the Minimum Funding Requirement (MFR) which makes transparency, not regulation, the safeguard. The review believes that a similar approach to tackling the broader issues set out in this report should be tried. The successful implementation of the Combined Code of the Committee on Corporate Governance, and its forerunner the Cadbury Code, demonstrates that a model for good practice, coupled with robust disclosure requirements, can act as a powerful force for behavioural change.
- 11.4 Using the existing Statement of Investment Principles as a starting point, the review proposes that annual reporting by all pension funds to their beneficiaries and other interested parties should develop into a forum for decision-makers to explain and justify their approach, and for stakeholders to exercise oversight of the decisions made on their behalf.
- 11.5 Set out below is a series of principles which codify the model of best practice which is the most important outcome of the review. As with the Combined Code, compliance with them would not mean strict reproduction of a specific organisational structure. The review hopes that its proposals will positively encourage diversity in investment approaches. However, the principles constitute a framework for good practice. If an institution's current arrangements do not fall within this framework, the review believes it should have to explain why it has chosen to adopt an alternative approach.

**The review recommends that pension funds should set out in their Statement of Investment Principles (which should be annually distributed to members) what they are doing to implement each of the principles. Where they choose not to meet a given principle, they should explain publicly, and to their members, why not.**

- 11.6 It is hoped that the industry will adopt voluntarily the requirement for pension funds to disclose compliance with the principles, and the review recommends that the Government should now consult with the industry on their detailed content, before promulgating them.

**However, the review believes that the scale of distortions it has identified would justify requiring funds to report their compliance with the principles through legislation, if the industry does not adopt them voluntarily.**

- 11.7 Moreover, it will be desirable to monitor how far the principles have been effective in actually affecting behaviour.

**The review recommends that in two years' time, the Government should undertake a public assessment of the effectiveness of the principles in bringing about behavioural change.**

- 11.8 The review also believes that similar principles should apply to the investment practices of life insurers and providers of collective investment vehicles.

**The review recommends that the review of personal investment products proposed in Chapter 9 should develop principles along similar lines for the product markets within its terms of reference.**

## Proposed principles: Defined Benefit Pension 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 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. 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 appropriate focus.

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**

Contracts for actuarial services and investment advice 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) of measurement and evaluation, such that the mandate will not be terminated before the expiry of the evaluation timescale other than for clear breach of the conditions of the mandate or because of significant change in the ownership or personnel of the investment manager.

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

The mandate should incorporate a management fee inclusive of any external research, information or transaction services acquired or used by the fund manager, rather than these being charged to clients.

#### 6. **Activism**

The mandate should incorporate the principle of the US Department of Labor Interpretative Bulletin on activism.<sup>1</sup> Managers should 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 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<sup>2</sup> 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 of advisers and managers and send them annually to members of the fund. The Statement should explain why a fund has decided to depart from any of these principles.

<sup>1</sup> See Chapter 5.

<sup>2</sup> This would also incorporate the transparency statement proposed by the review in its proposals for replacing the MFR.

## **Proposed principles: Defined Contribution Pension 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 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. 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 appropriate focus.

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***

In selecting funds to offer as options to scheme members, trustees should:

- consider the investment objectives, expected returns, risks and other relevant characteristics of each fund, so that they can publish their assessments of these characteristics for each selected fund; and
- satisfy themselves that they have taken their members' preferences into account, and that they are offering a wide enough range of options to satisfy the reasonable return and risk combinations appropriate for most members.

### **3. *Focus on asset allocation***

Strategic asset allocation decisions (for example for default and lifestyle options) should receive a level of attention (and, where relevant, advisory or management fees) that fully reflect the contribution they can make to achieving investment objectives. Decision-makers should consider a full range of investment opportunities, not excluding from consideration any major asset class, including private equity.

### **4. *Choice of default fund***

Where a fund is offering a default option to members through a customised combination of funds, trustees should make sure that an investment objective is set for the option, including expected returns and risks.

### **5. *Expert advice***

Contracts for investment advice should be open to competition, and fee rather than commission based. The scheme should be prepared to pay sufficient fees to attract a broad range of kinds of potential providers.

### **6. *Explicit mandates***

Trustees should communicate to members, for each fund offered by the scheme:

- the investment objective for the fund, its benchmark(s) and risk parameters; and
- the manager's approach in attempting to achieve the objective.



These should also be discussed with the fund manager concerned, as should a clear timescale(s) of measurement and evaluation, with the understanding that the mandate will not be terminated before the expiry of the evaluation timescale other than for a clear breach of the conditions of the mandate or because of significant change in the ownership or personnel of the investment manager. The management fee should include any external research, information or transaction services acquired or used by the fund manager, rather than these being charged to clients.

7. ***Activism***

The agreement with fund managers should incorporate the principle of the US Department of Labor Interpretative Bulletin on activism.<sup>3</sup> Managers should have an explicit strategy, including 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.

8. ***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 managers the freedom to pursue genuinely active strategies.

9. ***Performance measurement***

Trustees should arrange for measurement of the performance of the funds 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.

10. ***Transparency***

A strengthened Statement of Investment Principles should set out:

- who is taking which decisions and why this structure has been selected;
- each fund option's investment characteristics;
- the default option's investment characteristics, and why it has been selected;
- the agreements with 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.

11. ***Regular reporting***

Trustees should publish their Statement of Investment Principles and the results of their monitoring of advisers and managers and send them annually to scheme members. The Statement should explain why a fund has decided to depart from any of these principles.

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<sup>3</sup> See Chapter 5.

## CHAPTER 12:

# Private Equity

### Private equity: what and why

- 12.1 Private equity describes the wide range of risk capital investments made by specialist investment managers in all types of companies, using share capital that is privately held rather than publicly tradable. The review has two particular areas of interest: first, the contribution of private equity to wider economic growth and technological change in the UK economy; and second, the impact of regulation and taxation on UK institutional investors' ability and willingness to consider this type of investment.
- 12.2 The review has looked at economic and regulatory factors affecting *private equity* as a broad asset class, including the subgroup of investments known as *venture capital*. Although these terms tend to be used interchangeably, they refer to quite different types of investment. These can range from the injection of tiny amounts of seed capital for a company formation right up to the largest billion-pound corporate restructuring deal. The review follows the broad approach taken in the US, which distinguishes clearly between venture capital and non-venture private equity (primarily management buy-outs). The review's terminology derives from the British Venture Capital Association's (BVCA) definitions by investment stage. These are set out in the box below.

#### Definitions

##### **Venture capital:**

**Start-up:** Financing provided to companies for use in product development and initial marketing. Companies have not yet sold their product commercially.

**Other early stage:** Financing provided to companies that have completed product development stage and require further funds to start commercial sales. They may not yet be generating profits.

**Expansion:** Capital provided for the growth and expansion of an established company. Capital provided for rescue/turnaround situations is also included in this category.

**Refinancing bank debt:** By replacing existing liabilities with a mixture of debt and equity, the company obtains a more flexible financing package.

**Secondary purchase:** Purchase of existing shares in a company from another venture capital firm or from other shareholders.

##### **Non-venture private equity:**

**Management buy-out (MBO):** Funds provided to enable current operating management to acquire an existing product line or business. Institutional buy-outs (IBOs), Public to Privates and similar financings are included under MBOs for BVCA reporting purposes.

**Management buy-in (MBI):** Funds provided to enable an external manager or group of managers to buy into an established company.

**Public to Private:** Purchase of equity of publicly listed companies, which are then delisted to become private companies again. Private equity capital is provided to finance development of the private company, with a view to subsequent listing or trade sale.

## **Economic importance**

- 12.3 Private equity investment can provide the crucial combination of capital, business mentoring and financial discipline to help and encourage enterprises to realise their growth potential. This financing and business development process supports wider economic growth by enabling structural change and redeploying capital rapidly to new businesses in new sectors.<sup>1</sup> The transforming impact of venture capital, applied over decades now in California's 'Silicon Valley' and in other US regions, has been well documented: whole new industries have been fostered and their growth accelerated by the injection of risk capital seeking high absolute returns for both investor and entrepreneur.
- 12.4 The UK private equity market has followed developments in the US and leads the rest of Europe (although several continental European markets are catching up rapidly). Private equity capital has a distinctive role to play, particularly for smaller and younger companies, combining strong financial incentives for growth with mentoring and networking support to investee companies. But in an increasingly global capital market, the UK's enterprise sector will attract the finance it needs to grow only if it can generate sufficiently attractive returns to compensate investors for the risk of private equity exposure, and if there are efficient mechanisms to channel investment capital into funds and thence into growth businesses.

## **UK institutional investment approach to private equity**

- 12.5 There is significant *prima facie* evidence to suggest that UK investment institutions have not generally benefited from investments in the private equity arena to the same extent as their counterparts in the US. There are many reasons for this, not least the relative performances of UK and US private equity investment markets in recent decades. But to the extent that some of the UK institutions' apparent aversion to private equity investment may also be caused by the UK's regulatory and fiscal regime, or by broader issues in UK institutional investment, there is a role for the review to diagnose the causes and propose solutions.
- 12.6 The review does not set out to pass judgement on the level of investment in UK private equity, the balance between venture capital and MBOs/MBIs, the destination of UK-managed investment funds by stage of company, industrial sector or national location of investee, nor the source of capital for UK-based private equity funds. It is for each institutional investor to assess the relevance of private equity investment to the objectives of that particular fund. By the same token, each private equity firm must consider the sourcing of investment capital and where best to apply that capital to deliver returns to investors. These are commercial judgements which the review does not seek to influence. The review does, however, set out to identify the way current regulation and taxation of UK-based institutional investors, or broader problems in their approach, may distort their evaluation of investment opportunities in private equity, whether under UK or overseas management.

## **Impact of the review's wider proposals on investment in private equity**

- 12.7 The review believes that the proposals made so far in this report will have a significant and positive impact on decision-making about private equity.
- 12.8 More knowledgeable trustees with more in-house staff would be in a better position to understand the specific issues raised by private equity. Sponsors with a clearer interest in the potential benefits would also help create an atmosphere more likely to be favourable to private equity.

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<sup>1</sup> Gompras and Lerner, 'Venture Capital and the Creation of Public Companies', *Journal of Private Equity*, 1997; Fenn, Liang and Prowse, *The Economics of the Private Equity Market*, Federal Reserve Bank Staff Papers, 1995; European Commission, *Risk Capital Action Plan*, 1998.

- 12.9 The principles set out in Chapter 11 should create a clearer framework in which trustees can think about how private equity investment might contribute to the strategic objectives of their fund. In particular, the requirement to consider a full range of investment opportunities will be directly relevant to private equity. More generally, an overall investment objective that is liability-related would be much more consistent with private equity investment than a peer group benchmark or an asset allocation driven by a statistical modelling process. A focus on ensuring that decisions are taken by those best placed to make them is likely to be helpful to specialist asset classes. The decision to invest in private equity is made at the level of strategic asset allocation, so greater investment of time and resources into the asset allocation decision should be beneficial, and efforts to involve a wider range of advisers with specialist skills will encourage pension fund trustees to obtain quality advice on the role of private equity and its application, thereby boosting the demand for information services in the private equity market.
- 12.10 Replacing the Minimum Funding Requirement (MFR) with an approach based on transparency and disclosure (see Chapter 8) will remove a bias towards the reference assets used to calculate MFR funding; at present, this disadvantages investment in private equity. The suggestion that defined contribution schemes should use the investment trust vehicle as a means of accessing investment in private equity is also relevant, as is the call for more product innovation in this area.
- 12.11 At the same time, private equity raises a range of specific issues not covered by the analysis so far. The remainder of this chapter considers:
- types of private equity vehicles (paras 12-21);
  - the historical development of the UK, US and European private equity markets (paras 22-34);
  - the economic impact of private equity (paras 35-47);
  - its investment performance (paras 48-63);
  - sources of private equity investment (paras 64-75); and
  - drivers and barriers to UK institutions investing in private equity, making a series of recommendations for Government and the private equity industry (paras 76-106).

## Private equity investment vehicles

- 12.12 UK-based investors have a growing range of investment vehicles through which they can invest in private equity. The structure, regulation and taxation of some of these vehicles can create significant disincentives for many institutional investors.

### ***Direct investment ('captive' and 'semi-captive' funds)***

- 12.13 Under this model, funds are managed on behalf of a parent organisation by a venture capital firm which is a wholly owned subsidiary or division of the parent. This approach was widely adopted by the largest UK insurance companies and clearing banks during the 1980s. More recently, a number of 'captive' fund management groups have bought themselves out to become fully independent private equity firms. 'Semi-captive' refers to funds that are invested on behalf of the parent company together with funds raised from external sources. The trend in the UK market is towards independents: 'captive' and 'semi-captive' funds accounted for 23 per cent of the flow of private equity investment in 1999, down from 32 per cent in 1997<sup>2</sup>.

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<sup>2</sup> BVCA, *Report on Investment Activity 1999*.

## **Limited partnerships**

- 12.14 This is the dominant investment vehicle used in the UK, US and continental European private equity markets. The private equity firm acts as the general partner of the limited partnership, responsible for managing the fund, while institutions and other investors become limited partners. Returns to investors and the private equity firm are defined in the partnership agreement. This will typically involve annual management fees to the general partner of 1 to 3 per cent<sup>3</sup>, and a share in the capital gain of the fund (so-called 'carried interest', typically around 20 per cent), once it has reached a threshold return (typically around 10 per cent internal rate of return since the fund's inception, although this figure has been on a declining trend).
- 12.15 Limited partnerships have several advantages for both the private equity manager and the private equity investor:
- the limited partnership is 'tax transparent', meaning that income and capital gains flow through the partnership untaxed. Returns are taxed in the hands of end investors according to their own specific tax regime;
  - this is particularly important to tax-exempt pension fund investors;
  - considerable flexibility surrounds the structure and terms of each limited partnership, enabling private equity managers to tailor each partnership to the particular needs of the fund; and
  - each limited partnership has a fixed life. Capital gains are shared between the limited partner investors and the general partner private equity manager. This gives the latter strong incentives to invest for absolute capital growth over a defined period, to the benefit of the former.
- 12.16 The key disadvantages of the limited partnership are:
- limited partnership participations are not publicly tradable. Interests may change hands in the secondary market but there is no ready access to liquidity or a market price; and
  - English law governing limited partnerships is archaic. Based on the Limited Partnership Act 1907, it imposes strict constraints on the number of partners and on limited partners' involvement in investment advisory work.

## **Investment trusts**

- 12.17 With the rise of limited partnerships, investment trusts have become the minority investment vehicle in UK private equity. The sector is dominated by 3i, which has a market capitalisation of around £8 billion, a whole order of magnitude greater than the second largest investment trust in this sector – Electra, with a market capitalisation of £1 billion.<sup>4</sup> The fundamental difference between investment trusts and limited partnerships is the time-limited nature of the latter. Investment trusts are typically evergreen, with capital gains reinvested rather than returned to shareholders, who receive their investment returns through dividends and capital gains on trust shareholdings. Some investment trusts, such as Electra, have now become time-limited. The total assets of the top 11 UK-listed investment trusts focusing on private equity amount to some £11.4 billion.<sup>5</sup>

<sup>3</sup> Funds of funds' fees are typically at the lower end of this range, with early stage venture funds typically at the higher end.

<sup>4</sup> Market capitalisation as at 6 March 2001.

<sup>5</sup> Dresdner Kleinwort Benson, Venture Capital and Private Equity Investment Trusts, December 2000.

12.18 The main advantages of investment trusts are:

- they are tax transparent to end-investors (that is, no corporation tax is charged on the income or gains from the trust's investments), provided essentially that the trust meets Inland Revenue rules for distributing income to investors;
- as they are publicly quoted, they offer some degree of liquidity and market valuation; and
- they can access capital from a very wide range of institutional and individual investors through a public offering.

12.19 The disadvantages are:

- time lags between the raising of capital and its investment, which dilute the pure private equity returns from the trust and create pressure on private equity trust managers for early investment;
- only indirect linkage between trust share prices and their net asset values, due to fluctuating supply and demand in the market for trust shares;
- weaker control by investors of private equity managers, as dispersed shareholdings and recycling of capital avoid the discipline of periodic fund-raising<sup>6</sup>; and
- imperfect 'tax transparency' for some overseas investors, who may be subject to overseas withholding taxes on distributions. This is a barrier to the creation of a pan-European private equity investment trust, which would be tax efficient for a full range of institutional and private investors.

12.20 Some of these disadvantages are being addressed in the market. Measures include the issue of participating loan notes to enable investment trusts to draw down cash when needed; share buy-backs to help align net asset values and share prices; and more sophisticated independent analysis of private equity trusts' strengths and weaknesses.

## ***Funds of funds***

12.21 Structured as either limited partnerships or investment trusts, these vehicles invest in a range of other partnerships and/or trusts to provide the fund of funds' own investors with a diversified private equity portfolio. This can be spread across the full private equity spectrum, making the funds suitable for smaller institutional investors who may be unable to manage their own private equity fund investments economically. Alternatively, the fund may diversify within a specific niche sector, giving institutions a balanced exposure to complement their own direct investments in other private equity funds. The advantages for investors are access via experts to private equity funds, including popular funds that might otherwise be effectively closed to individual institutions and especially those new to private equity. Another benefit is built-in portfolio diversification. Against this, however, investors incur an additional layer of management expense.

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<sup>6</sup> Although the presence of a board of directors with a majority of members independent of the manager should foster good governance.

## Hedge Funds

Private equity is only one of several different types of alternative asset class, alongside others including hedge funds. Hedge funds use a variety of investment strategies to seek to exploit inefficiencies in markets, and according to some estimates have grown in number from as few as 300 in 1990 to anything up to 5,000 today, managing some \$200 billion to \$400 billion. A hedge fund is effectively an unregulated investment pool which may invest variously. Because they are free from regulatory and disclosure requirements – and often small – hedge funds can be extremely flexible in their investment options and change their portfolio faster than larger regulated vehicles.

Hedge fund investing originally involved managers' taking positions in individual securities which were either long or short on the basis of their views on the valuation of that security.<sup>7</sup> But over the years the term 'hedge fund' has come to encompass a wide variety of alternative investment strategies.

### *Taxonomy of hedge fund strategies*

- Trading strategies (based on speculation about market direction in multiple asset classes).
- Relative value strategies – arbitrage – focused on the spread relationships between pricing components of financial assets – (may involve minimal market risk but often requires leverage to enhance returns).
- Specialist credit strategies (involves lending to credit sensitive issuers, for example, firms in or near bankruptcy, following a high level of due diligence work identifying mis-priced securities).
- Stock selection (combinations of long and short positions, normally in equities, aiming to exploit under and overvalued securities).

Hedge funds tend to target significantly higher returns than funds managed in a more conventional manner. A number of factors may help them to do so:

- they are focused on their own areas of expertise, tending to avoid risks outside those areas;
- they operate on a performance fee structure which, it is argued, attracts successful managers and incentivises them; and
- hedge fund managers will often have their own money invested in the fund.

Moreover, there tends to be very little correlation between the performance of one type of hedge fund and another (in contrast to active fund managers), and between most hedge funds and market indices. Investment in one or more hedge funds (or a carefully constructed fund of funds) can therefore generate superior risk-adjusted returns, which are uncorrelated with the remainder of a typical institutional investor's portfolio. However, the selection of funds is crucial, and must take place on the basis of careful research, since – as is also true of private equity funds – the dispersion of returns for hedge funds is much wider than for conventional active management, as are the sources of competitive advantage, risk and return.

There has historically been caution about hedge fund investing on the part of institutions, with high net worth individuals providing the primary client-base for most hedge funds. There has been limited understanding of the different styles of hedge fund and the risk diversification and return enhancement potential they can provide; fees tend to be high, and charged on a performance basis; and the positions taken by a hedge fund manager are likely to be significantly different to the consensus – a very different set of characteristics to those with which many institutional investors tend to be comfortable. Moreover, there are significant capacity constraints, with many high-profile funds closing to investors very soon after opening. However, both hedge fund managers and investment consultants told the

<sup>7</sup> 'Shorting' a security means agreeing to sell stock (which the manager does not own) at an agreed price. The manager hopes that the stock will fall in price, so that it can be repurchased at a profit.

review that there has recently been increased interest in the asset class from institutions – often seeking to allocate a small proportion of their portfolio to it, perhaps by investing in a fund of funds. Many of the larger financial institutions are now setting up their own funds, both to retain their talented management staff, and to attempt to meet the demand for hedge fund investment from existing and new clients.

## Private equity: historical context and current market structure

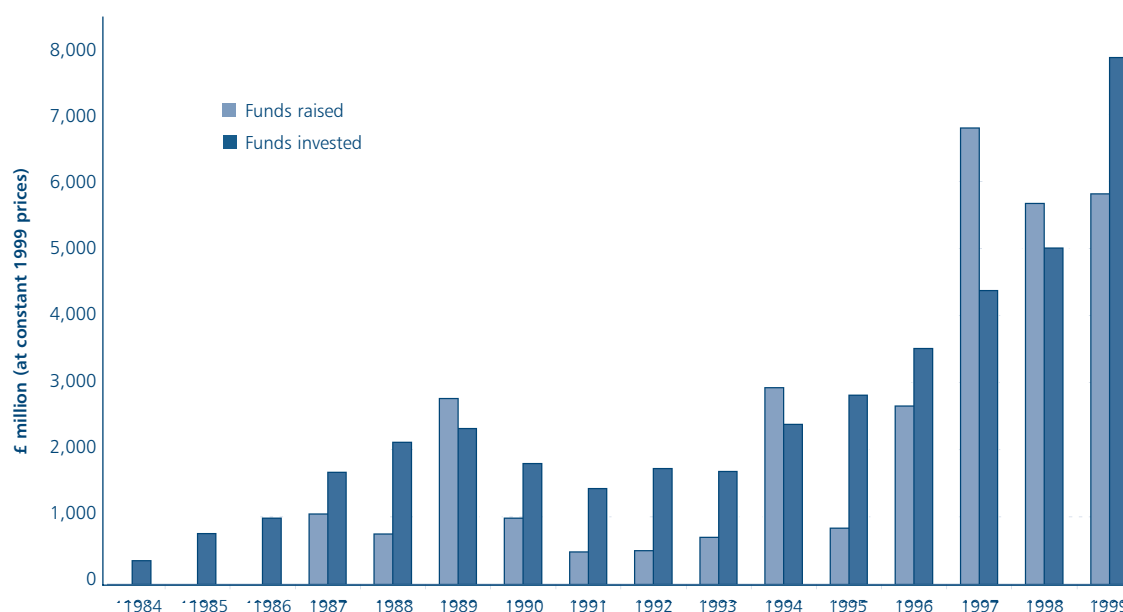
12.22 This section describes the development of private equity in the UK. It looks – more briefly – at the historical development of private equity in the US and at more recent developments in continental Europe. Focusing on both the pattern of capital flows and the performance of investment, it also identifies some of the factors behind the performance of UK and US private equity and venture capital.

### UK private equity: historical development

12.23 Venture capital in the UK can trace its origins back to the 1930s at least, with the founding of Charterhouse and the identification of the ‘equity gap’ for smaller unquoted companies by the Macmillan Report in 1931. The industry took a major step forward with the creation of the Industrial and Commercial Finance Corporation (ICFC) in 1945. ICFC/3i was the dominant venture capital and private equity investor in the UK for several decades. By the mid-1970s there were around a dozen private equity firms, rising to two dozen by the time the Wilson Committee on the financing of small firms reported in 1980.

12.24 The BVCA was founded in 1983 with 34 member firms. During the 1980s and early 1990s the growth in the number of new private equity and venture firms slowed and some firms consolidated. This was reflected in the value of investments by BVCA members, which rose to around £1 billion in 1987 and remained at or only slightly above that level until 1994. Since the mid-1990s, there has been a substantial and sustained increase in the funds raised and in investment made by UK private equity funds, rising to £7.8 billion and £5.8 billion respectively in 1999. The number of BVCA investment manager members has risen to 124, with a further 21 associated members from corporate finance and asset management.

**Figure 12.1: Funds raised and invested by BVCA members**

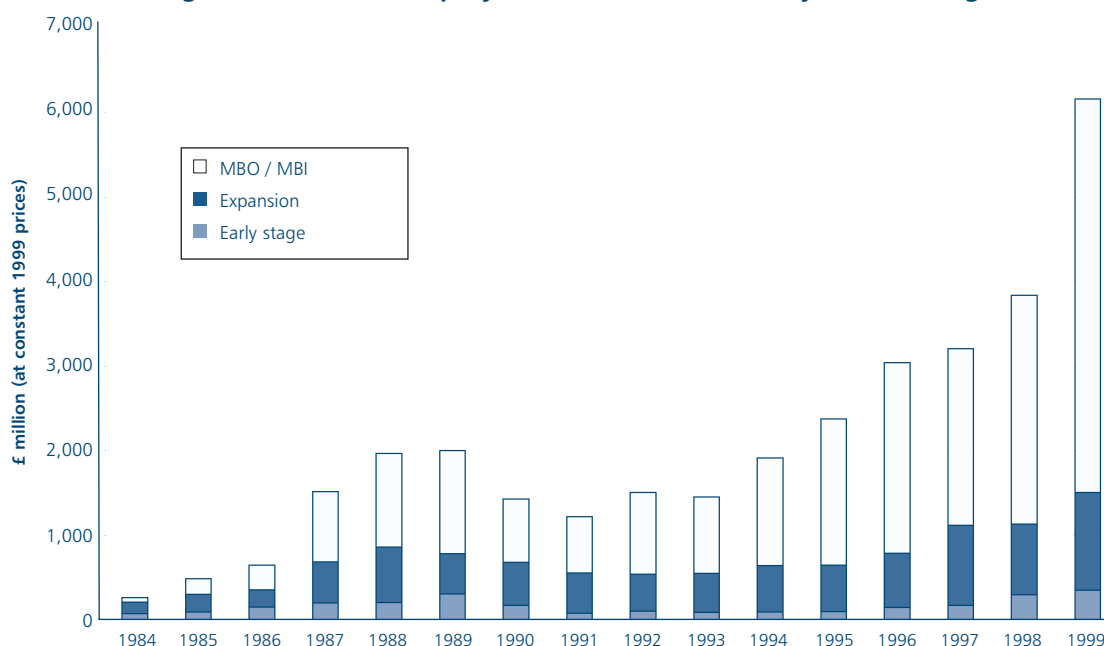


Source: BVCA Report on Investment Activity 1999



- 12.25 The UK private equity industry has had a long historical connection with the wider UK capital market, on both the corporate finance and institutional investment sides. ICFC/3i was owned for most of its life by the UK banking sector. Since the 1980s, several of the major clearing banks have operated their own in-house private equity firms<sup>8</sup>, mostly focusing on management buy-outs and buy-ins. The larger insurance companies have invested their own funds through in-house private equity firms, again primarily focused on MBOs and MBIs<sup>9</sup>. Major fund management groups have also developed a private equity investment capability.<sup>10</sup>
- 12.26 In addition to these captive or semi-captive private equity firms, the number of fully independent firms is increasing. Before the tax treatment of limited partnerships was clarified in 1987, many of these private equity funds were structured as investment trusts.<sup>11</sup> During the 1990s, an increasing number of independent funds were structured as limited partnerships, with a series of funds raised and invested by new and relatively small independent private equity partnerships.
- 12.27 Several respondents contrasted the earlier prevalence in the UK of 'tied' private equity firms with the greater role played by fully independent venture capital and private equity firms in the US. In their view, this had contributed to the UK private equity industry's poorer performance relative to the US. Channelling institutional investment via in-house funds may have hindered the development of a diversified private equity portfolio and reduced competition between different private equity firms and investment approaches.
- 12.28 The pattern of investment by UK private equity over the past two decades has focused increasingly on MBOs and MBIs, with dramatic increases in the scale of funds under management and in the size of individual deals. In the mid-1980s, venture capital accounted for over half of UK-managed private equity investments; by 1999, that proportion had fallen to around 25 per cent<sup>12</sup>.

**Figure 12.2: Private equity investment in the UK by finance stage**



Source: BVCA Report on Investment Activity 1999

<sup>8</sup> For example, Barclays Ventures and Barclays Private Equity, NatWest Equity Partners (now Bridgepoint Capital).

<sup>9</sup> For example, PPM Ventures at Prudential, Legal & General Ventures.

<sup>10</sup> For example, Schroder Ventures, Phildrew Ventures.

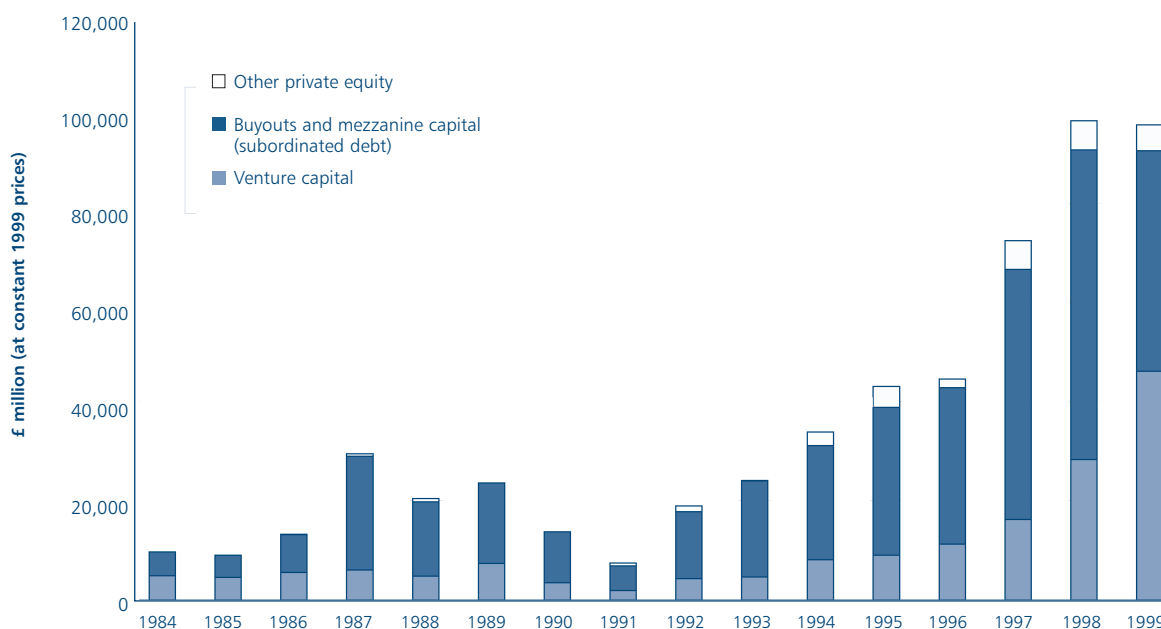
<sup>11</sup> For example, Candover.

<sup>12</sup> BVCA Report on Investment Activity 1999.

## US private equity: historical development

- 12.29 In some ways, development of the US private equity market has been similar to the UK; certainly its roots lie in funds launched in the late 1940s. Significant differences with the UK have been the strong growth in venture capital (in tandem with non-venture private equity, and including major waves of technology investing); the diversity of funding sources; and, in the past decade and a half, the sustained high level of returns across the full range of private equity investments.
- 12.30 The US private equity industry started with the formation of the American Research and Development Corporation in Boston in 1946. Over the following decades the venture industry evolved, sometimes erratically, as fund-raising followed periods of good investment returns. These in turn were closely linked to the performance of initial public offerings (IPOs) on public equity markets. Factors stimulating market development included the government-backed Small Business Investment Company (SBIC) programme, which catalysed the creation of a large number of new venture firms focused on small enterprise investment by leveraging private finance with loans from the Small Business Administration; and the rise of the limited partnership as the model for private equity investment.
- 12.31 The 1980s and 1990s saw explosive growth in venture capital commitments and – even more strikingly – in non-venture private equity. This was triggered by a favourable combination of factors, including major reforms of capital gains and share option taxation, liberalisation of pension fund regulations, and a stronger general economic climate for enterprise creation. The buoyant performance of the US equity markets and the development of the NASDAQ market (which provided earlier access to public markets for venture-backed firms) also played a major role in boosting venture returns.<sup>13</sup>

**Figure 12.3: Commitments to US private equity and venture capital partnerships**



Source: NVCA Yearbook 2000

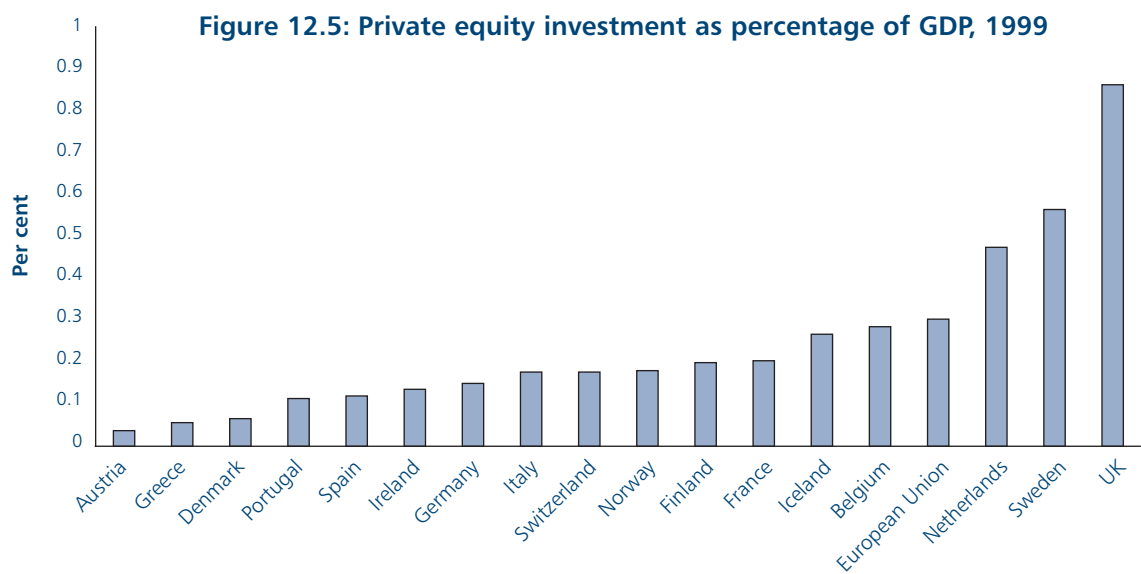
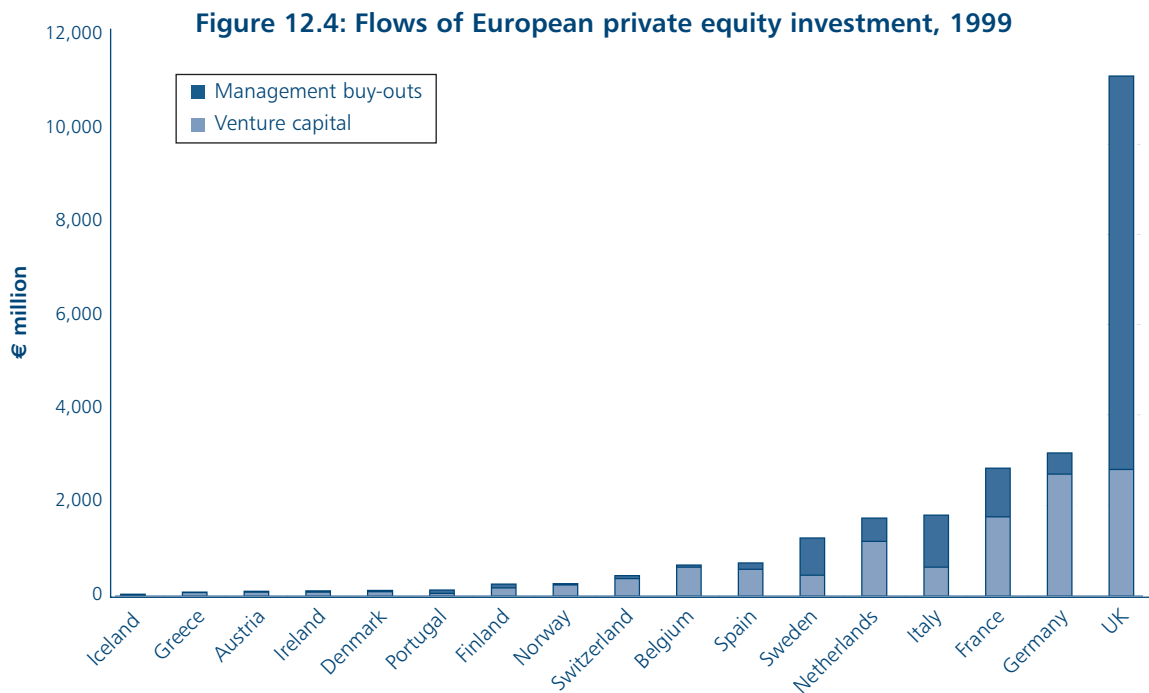
- 12.32 Independent partnerships have come increasingly to dominate the US venture capital market. In 1999, they accounted for around 80 per cent of funds under management, up from 40 per cent in 1980. Financial and industrial companies accounted for around 18 and

<sup>13</sup> For a fuller description of the US private equity market, see Fenn, Liang and Prowse, *The Economics of the Private Equity Market*, Federal Reserve paper, 1995.

3 per cent respectively. There are now 620 or so venture firms which are managing actively investing limited partnerships, up from 95 in 1980 and 390 in 1990. The net rate of creation of new venture firms has increased sharply in recent years: to 73 in 1999, up from an average of 32 per annum during the 1980s. But the industry 'model' has remained remarkably stable. Each firm has an average of six investment principals, even though average investment capital per principal rose from \$6 million in 1980 to \$16 million in 1990 and \$37m in 1999.<sup>14</sup>

### Continental European private equity: historical development

12.33 The European private equity market is dominated, in volume terms, by the UK's MBO and MBI market. Of the €25 billion invested in European private equity in 1999, the largest proportion went to the UK (€11.5 billion). Buy-outs accounted for €13.3 billion (53 per cent) of European total investment in 1999, of which €8.7 billion went to the UK.<sup>15</sup>



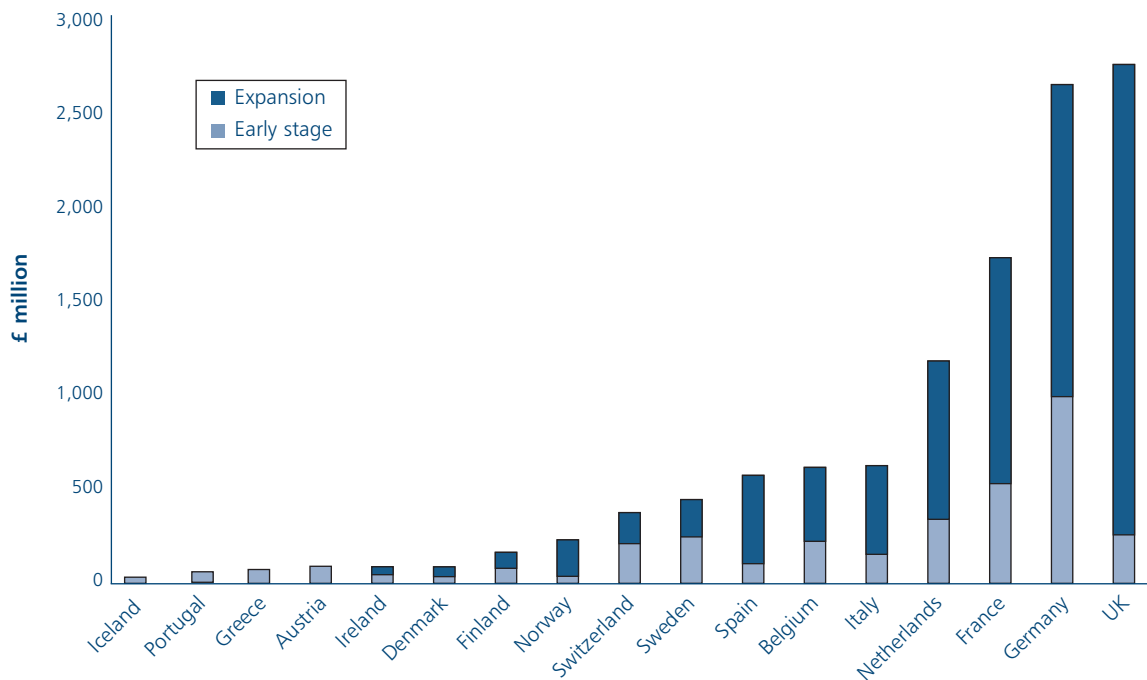
<sup>14</sup> All data from *NVCA Yearbook 2000*, prepared by Venture Economics.

<sup>15</sup> European Venture Capital Association.

12.34 To a lesser extent, the UK also dominates the rest of the EU in the absolute amount of venture capital investment. This results largely from the substantial amount of expansion capital invested in the UK. When the size of the economy is taken into account, however, the UK's venture investment as a percentage of GDP falls to fourth in the EU (Figure 12.7 below). Looking at early stage investment, the UK performs relatively poorly against the rest of Europe: investment per head ranks tenth in the EU and below the EU average. Several factors have contributed to the UK's relatively poor performance in venture capital, and especially early stage venture capital, compared with recent continental European results:

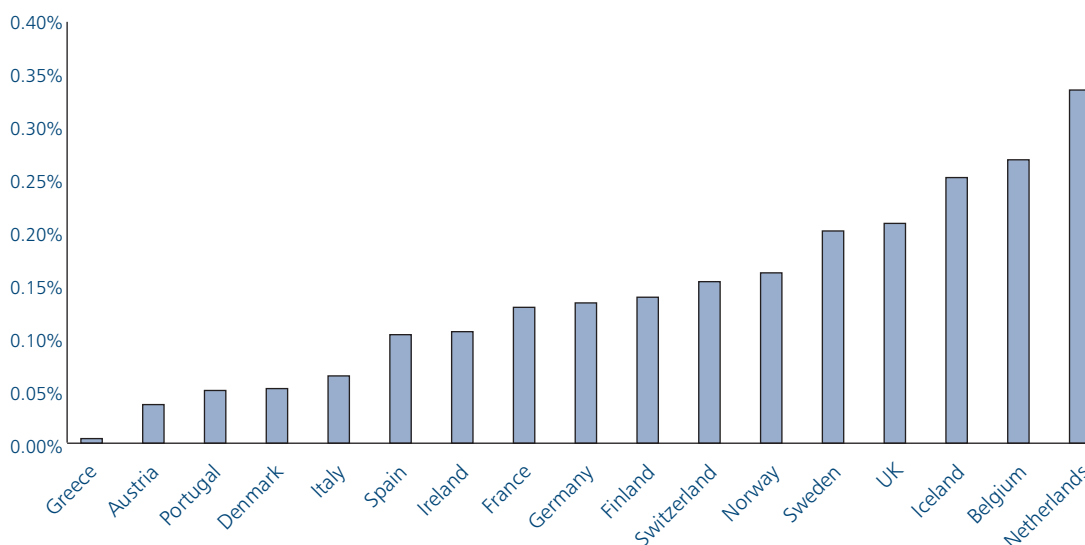
- much initial UK experience with early stage and particularly technology venture capital produced poor investment returns, leading to a migration of skills and investment capital away from this part of the market. Subsequent higher returns from later-stage venture and MBO funds reinforced this as the focus of UK private equity development;
- later development of venture capital in Germany, the Netherlands and Scandinavia may have enabled funds there to learn from earlier UK experience;
- the Governments of these same countries have been active investors in programmes to commercialise technology emerging from universities and public sector research laboratories. They have also adapted earlier institutions aimed at supporting bank financing of small and medium-sized enterprises to stimulate venture capital developments; and
- exit routes for venture capital investments improved substantially in the late 1990s. Germany saw the creation of the Neuer Markt for young, mainly technology-based companies; while in Scandinavia, access to public markets improved markedly.

**Figure 12.6: EU Venture capital by finance stage, 1999**



Source: EVCA Yearbook 2000

**Figure 12.7: Venture capital investment as a percentage of GDP, 1999**



Source: EVCA Yearbook 2000

## Private equity: economic impact

12.35 Private equity is a powerful but specialised form of financing, relevant to only a small minority of companies with the potential and ambition to grow rapidly. Any increase in the supply of private equity and, within that, venture capital, will not automatically find a corresponding increase in demand from enterprises able to meet the private equity investors' *ex ante* expectations of returns. Institutional investors are therefore rightly concerned about the extent to which the economies of the UK, Europe and even the US can continue to absorb the increased funds allocated to this asset class in recent years, and invest them productively. This section places the private equity market into the wider context of financing for small and medium-sized unquoted businesses. It highlights the robust finding that although private equity remains a niche activity, successfully backed enterprises have a disproportionate impact on national productivity gains, employment creation, and technology diffusion.

12.36 Out of a total of some 750,000 companies in the UK, only 1,100 received private equity investment in 2000 – a statistic that serves to underline the specialist nature of private equity. This niche pattern is repeated in other markets. In the US, for example, some 3,600 companies received venture finance in 1999 (a substantial increase on 2,500 in 1997, and only around 1,200 companies per annum in the early 1990s). Interestingly, in 1999 significantly more companies across Europe as a whole were venture-financed, around 6,800, up from 4,600 in 1998. More UK companies are likely to have received informal venture finance from business angels – perhaps up to 5,000 (assuming annual business angel investment of around £500 million and average total business angel investment per company of around £100,000<sup>16</sup>). This aspect of the venture market is significantly more developed in the US. Despite wide variation in views of the scale of the informal venture capital market, conservative estimates suggest that about 250,000 angels invest approximately \$10 billion to \$20 billion every year in the US in over 30,000 ventures.<sup>17</sup>

<sup>16</sup> Research on business angels by Colin Mason and Ian Harrison, for example, 'An overview of informal venture capital research', *Venture Capital Journal*, 1999.

<sup>17</sup> J E Sohl, 'The early stage equity market in the USA', *Venture Capital Journal*, 1999.

- 12.37 The demand for venture capital is narrowly based. UK surveys<sup>18</sup> estimate that around 9 per cent of small and medium-sized enterprises (SMEs) sought venture finance over the three years 1995-97, and just under 5 per cent obtained it. Venture finance accounted for just over 3 per cent of total external finance obtained by the whole sample of SMEs. Over 6 per cent of firms surveyed received external finance from other private individuals (business angels and family or friends).
- 12.38 The factors affecting the demand for venture capital are complex. Corporate finance theory suggests that external equity should be the most expensive form of financing for a growing enterprise, and it should therefore be financing of last resort. Entrepreneurs may have concerns about some loss of control as well as the cost of finance. A recent survey<sup>19</sup> concludes that the main concerns about private equity voiced by SMEs are: dilution and loss of control; loss of management freedom; target pressure from third parties; and financing costs.
- 12.39 The supply of private equity can be analysed according to many factors, including size, geography, sector, and stage of investment. For the UK, the key trends are as follows:
- The average size of private equity deals is rising sharply across all investment stages. This trend is mirrored in the US private equity and venture capital market.
  - Private equity investment is increasingly concentrated in London and the South East. This appears to result from the benefits of private equity executives networking with investors, professional advisers and each other; and increasingly, the pool of technology-based companies located within easy access of London (for example, in Cambridge, Oxford and the Thames Valley). Across Europe, private equity and particularly venture capital investments are more evenly distributed, although key clusters exist for venture finance. In the US, venture investments are concentrated in California (taking 43 per cent of total US venture investment in 1999<sup>20</sup>), followed by Massachusetts (9 per cent), New York (6 per cent) and parts of Texas (5 per cent).
  - In the UK, venture capital investment is increasing absolutely while declining as a share of total UK-managed private equity. By contrast, in the US the share of venture finance in private equity has been increasing in recent years. The European trend follows the UK rather than the US pattern, although across Europe there has been a marked rise in the share of early stage venture finance. The contrast between the UK and US is largely attributable to the different relative returns between venture and MBO funds, discussed further below.
  - Technology investment has increased sharply in absolute terms and relatively since the mid 1990s.
- 12.40 The economics of the industry are driving up the average size of private equity deals. The 'carried interest' mechanism gives private equity managers personal incentives to invest larger funds which would give a higher absolute return (for a given rate of return on the underlying investments). In the short run, other factors are also serving to increase average deal sizes, including the relatively fixed supply of experienced private equity managers, coupled with an increase in the supply of finance and a limit on the number of investments that one individual can manage effectively. Compared to the US, fewer new firms have entered the UK private equity industry, particularly from industry and technology backgrounds.

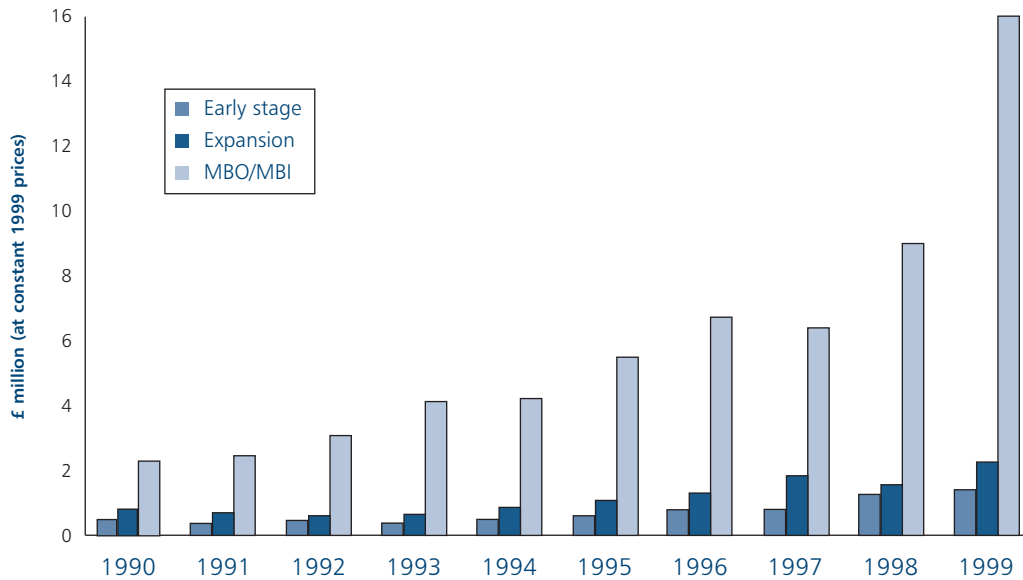
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<sup>18</sup> Cosh and Hughes (eds), *British Enterprise in Transition*, ESRC Centre for Business Research, 2000.

<sup>19</sup> Poutziouris, Chittenden and Michaelas, *The Financial Development of Smaller Private and Public SMEs*, Manchester Business School, 1999.

<sup>20</sup> *NVCA Yearbook 2000*, prepared by Venture Economics.

**Figure 12.8: Average deal size for UK private equity, by finance stage**



Source: BVCA Report on Investment Activity 1999

- 12.41 The performance of firms backed by venture capital and private equity is ultimately reflected in the financial returns paid to investors. This is discussed in some detail below. Here the review examines alternative measures of the wider economic impact of venture-backed firms.
- 12.42 Private equity can contribute through the *ex ante* selection of growth prospects, as well as monitoring and control after investment. This can help improve company development. In technology sectors, it can also increase the rate and effectiveness of innovation, by facilitating links between investee companies and other technology users and suppliers. UK survey evidence shows that investee firms value private equity investors primarily for their role as a sounding board for ideas, for challenging the status quo, providing financial advice, and for corporate strategy and direction.
- 12.43 Many respondents to the review considered that the US venture capital industry had been more successful than the UK industry in adding value to their investee companies through corporate strategy and especially through networking on their behalf. In part this appears to be due to the industry and technology backgrounds of many US venture capitalists:

*'Although those with a history of financial engineering may be well suited to the buy-out market, venture capital investments require a lot more than financial innovation.'*

*'The UK venture capital industry needs more engineers, scientists and entrepreneurs rather than MBA students from merchant banks. To grow the best companies venture capitalists must add value beyond mere financial engineering.'*

*'One of the key factors behind the venture capital success story in the US is the number of entrepreneurs, scientists and engineers that are involved. Their experience and networks are invaluable to a young high growth firm.'*

- 12.44 At the same time, the UK private equity industry has become heavily reliant on informed US investors for its funding. This is analysed below.
- 12.45 The concentration of US venture capital in Northern California, and to a lesser extent parts of New England and Texas, has clearly facilitated this networking benefit. Another likely factor is the greater role played in the US by venture executives with industry or entrepreneurial

backgrounds, rather than accountancy or investment banking. The review was told that for some this has tended to encourage investment in US rather than UK venture funds. A number of major UK institutional investors expressed this concern to the review.

- 12.46 On the issue of innovation, there is striking evidence from the US that venture funding has supported a substantial output of innovative activity. Recent evidence<sup>21</sup> suggests that the surge in venture capital investment from the late 1970s in the US brought with it a subsequent rise in patenting rates. It is estimated that venture capital accounted for 8 per cent of industrial innovations in the decade ending 1992. This evidence further suggests that by 1998, venture funding is likely to have accounted for about 14 per cent of US innovative activity. The strength of the US science base accounts for part of this success: US venture capitalists are feeding off a fertile base of technology emerging from universities and research institutes. This quantitative finding is borne out by the many individual cases of US venture-backed companies that have grown on the back of technology developments and then gone on to support the venture financing of the next generation of enterprises in their sector. The development of Hewlett-Packard and its impact on Silicon Valley is a classic example. UK venture capital has achieved some notable successes among technology investments (such as software-related firms founded in and around Cambridge<sup>22</sup>), but has yet to achieve the critical mass of the US venture industry.
- 12.47 When assessing the performance of private equity-backed firms, it is important to distinguish between venture capital and MBO/MBI activity. Finance is applied to investee firms at very different stages in their development, creating different opportunities and challenges in realising their growth potential.

### Management Buy-outs and Management Buy-ins: Economic Impact

MBO/MBI activity has increasingly come to dominate the UK private equity market, taking some 75 per cent of total investment in 1999. As borne out by US experience, this financing has enabled businesses to restructure in ways that are economically beneficial. The sustainability of returns from this activity is by no means guaranteed, however. Potential returns in future may be affected by low inflation, a more competitive corporation transactions market (where more deals are auctioned), and the substantial business restructuring in the UK undertaken over the past two decades. In this potentially less favourable environment, some investors have questioned whether UK private equity specialists in MBO/MBI deals add sufficient value to their investee companies to deliver consistently good future returns. Addressing this challenge will require greater diversity of skill, competency and experience in private equity management groups.

Nevertheless, the £16.9 billion invested in MBO/MBIs in 1999 was a record high, following substantial growth since the early 1990s. Since the mid-1990s, the number of deals per year has ranged between 600 and 700 but the deals themselves have become larger. This is particularly the case for MBIs, which now average £50 million compared with less than £20 million for MBOs. The rise in very large MBIs means that MBIs now dominate MBOs by value.

Over the last decade, financial returns from MBOs/MBIs have performed consistently well against public equity market comparators. (Private equity returns are discussed in more detail below.) On comparisons of three, five and ten-year returns to 1999, large MBO/MBIs have produced annual internal rates of return (IRR) of 31, 26 and 23 per cent respectively, considerably higher than the FTSE All-Share returns of 20, 20 and 15 per cent per annum for the same periods. Mid-sized MBOs/MBIs have also exceeded the FTSE All-Share over the medium to long term, falling just short on the three-year return.

<sup>21</sup> Kortum and Lerner, 'Assessing the contribution of venture capital to innovation', *Rand Journal of Economics* (forthcoming).

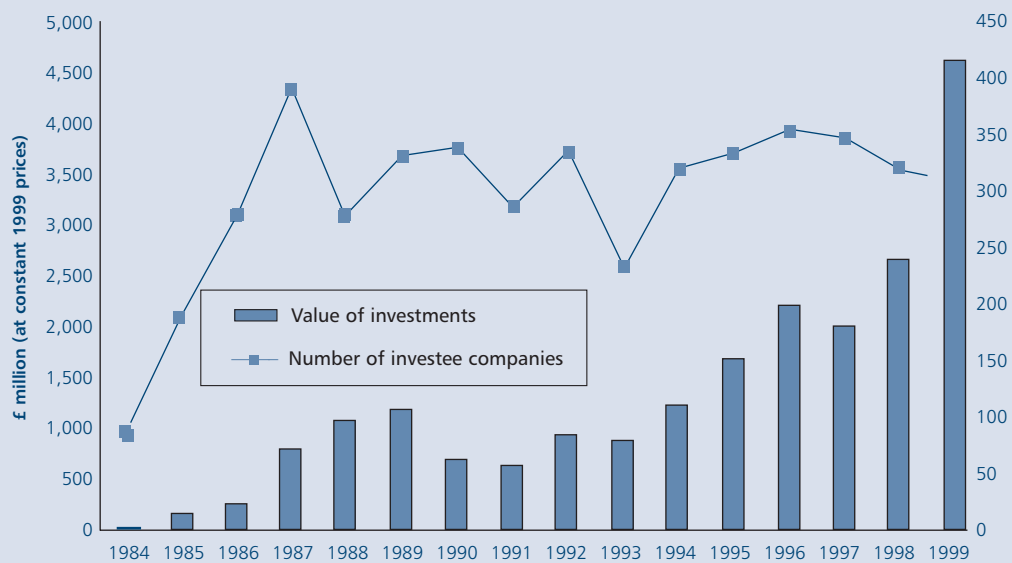
<sup>22</sup> For example, Autonomy, ARM Holdings.



In addition to such persuasive performance data, there is considerable empirical evidence that buy-outs in the UK have created value in the investee company, rather than simply transferred it to the investors.<sup>23</sup> Buy-outs have been shown to lead to significant improvements in profitability, both in the company's own terms and in comparison with non-MBO firms in the same sector. Profitability tends to surge around three to six years after a transaction and then returns to industry averages. This suggests that the discipline of private equity investment to capitalise on under-utilised assets has a pronounced one-off impact. Productivity increases are also shown to follow the same pattern of a medium-term surge; but here a significant longer-term productivity gain survives. The net effect on employment tends to produce an initial reduction (typically in non-production workers) as costs are rationalised, followed by an expansionary period that may more than offset the initial reductions.<sup>24</sup>

The empirical evidence suggests that driving the performance of MBO/MBI-backed companies are the substantial managerial and employee share incentives usually introduced at the time of the investment. The managerial discipline imposed by a debt repayment schedule for leveraged companies has a positive impact up to a point, but high leverage also brings with it a greater possibility of failure.

**Figure 12:9: UK Management buy-out/buy-in activity**

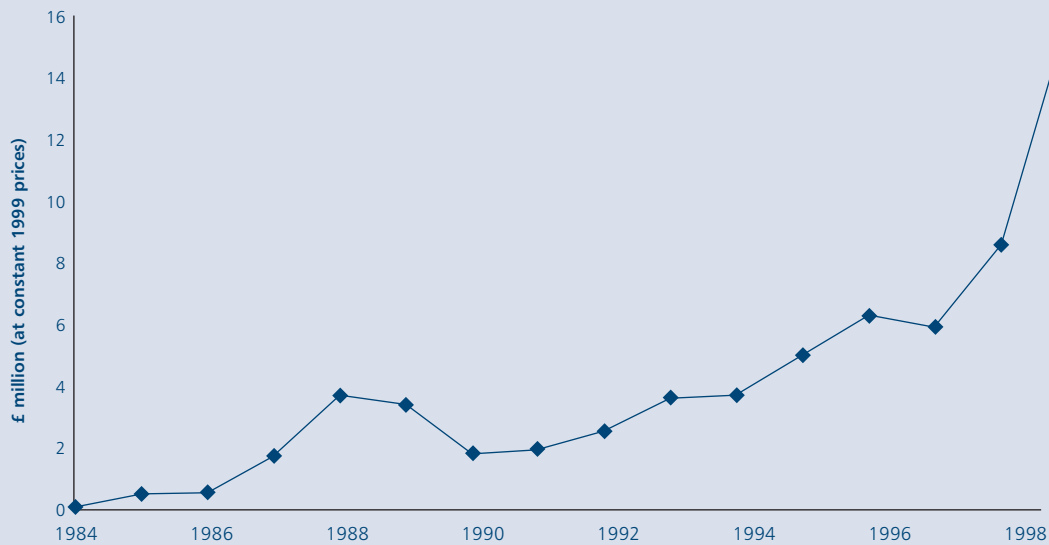


Source: BVCA Report on Investment Activity 1999

<sup>23</sup> Wright, Wilson, and Robbie, 'The Longer Term Effects of Management-Led Buy-Outs', *Entrepreneurial and Small Business Finance*, 1998.

<sup>24</sup> Thompson and Wright, 'Management Buy-Outs in the Short and Long Term', *Journal of Business Finance & Accounting*, 1995.

Figure 12.10: Average value of UK MBO/MBI deals



Source: BVCA Report on Investment Activity 1999

## Private equity investment performance

- 12.48 This section describes the absolute and relative performance of private equity funds over the last 20 years.
- 12.49 When assessing the performance of private equity it is important to focus on long-term returns. Initial returns over the first two or three years can be misleading if viewed in isolation. High rates of short-term return can be achieved through a few attractive divestments, while low rates may result from new funds only just beginning their investment activity. So any consideration of returns over the short term must be done in combination with scrutiny of the level of investment and divestment activity.
- 12.50 The net returns per annum to investors in UK-managed private equity funds raised between 1980 and 1995<sup>25</sup> have outperformed public equity market comparators over one, three, five and ten-year periods. The overall net return to investors since inception<sup>26</sup> now stands at 15.9 per cent per annum.<sup>27</sup> Over the past ten years, private equity as a whole has outperformed UK equities<sup>28</sup> by a margin of 540 basis points on annual returns; over five years this margin rises to 740 points.<sup>29</sup>
- 12.51 This performance by total private equity masks considerable variation by the year in which funds were raised (known as the 'vintage year') as well as by investment type and between individual funds. There is also considerable divergence in the returns attributed to different investment stages. The buy-out and generalist segments of the industry have significantly outperformed early stage and development venture funds over the longer term. However, over the past five years early stage returns have experienced a sharp improvement.

<sup>25</sup> Unless otherwise stated all data referring to investment horizons (3-year, 5-year, 10-year or 20-year periods) are calculated up to the end of 1999, which are the latest data available.

<sup>26</sup> Returns since inception: the average annual IRR, calculated from a fund's vintage year (the year that it was raised) up to end 1999.

<sup>27</sup> Source for all data in this section, unless otherwise stated: WM / BVCA, *Venture Capital and Private Equity Performance Measurement Survey*, 1999.

<sup>28</sup> UK Equity returns from the WM All Funds Universe.

<sup>29</sup> All performance figures in this section are net of costs and fees and refer to the IRR, which is the industry-standard for private equity performance measurement.

**Table 12.1: UK private equity returns by investment stage, Net IRR per cent per annum, to end 1999**

Fund type	1 year	3 year	5 year	10 year
Early stage	40.9	15.8	16.7	8.7
Development	43.8	30.4	27	12.6
Mid-MBO	23.5	19.9	22.1	17.4
Large MBO	23.9	31	26.4	23
Generalist	50.3	39.2	32.3	22
Total	33.6	31.1	27.2	20

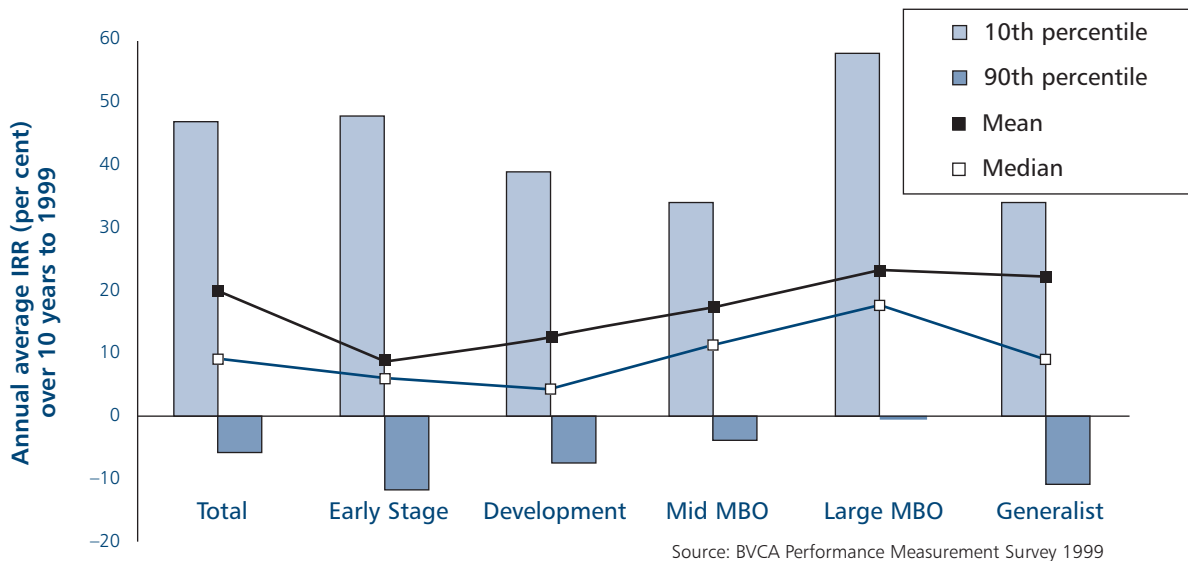
Source: WM / BVCA, Performance Measurement Survey 1999

- 12.52 Private equity returns are cyclical, reflecting movements in the public equity markets, linked in particular to movements in the UK sector for smaller market capitalisation companies. Indeed the peaks and troughs in the public equity market appear to be magnified in the private equity arena. It is not surprising that private equity returns move in parallel with public equity markets. Returns from buy-out funds, which account for the majority of the private equity market, depend on the valuations at entry and exit, both largely based on public equity markets. Such cyclical influences naturally produce considerable divergence in investment returns according to the 'vintage year'.
- 12.53 The difference between returns to funds raised at different points of the cycle can be quite pronounced. For instance, ten-year overall annual private equity returns for funds raised in 1986 were 6.1 per cent per year, compared with 21.7 per cent per year for funds raised in 1989. Since inception, 1994 funds have shown the best performance (32.2 per cent per year) while 1987 funds have shown the lowest returns (8.2 per cent per year).
- 12.54 Furthermore, the range of returns<sup>30</sup> varies according to the investment stage and vintage year. Not surprisingly, given the riskier nature of the investment, early stage funds have produced the widest range of returns (49.7 per cent per year) since inception. Large MBOs have also produced a wide range of returns (49.5 per cent). Generalist funds have had the narrowest range, with a spread of 35.4 per cent.
- 12.55 Over the past ten years, the performance of the better funds (at the top 10th percentile<sup>31</sup> of private equity) has been outstanding: 46.8 per cent per year across private equity funds; 48.3 per cent per year for early stage venture capital funds; 58 per cent per year for large MBO funds. However, the poor results at the bottom 10th percentile emphasise the importance when investing in private equity of diversifying to minimise risk: 6.6 per cent per year across all private equity; 12.4 per cent per year for early stage venture capital funds; 0.3 per cent per year for large MBO funds.

<sup>30</sup> The range is defined as the difference between the return at the 10th and the 90th percentiles. The top decile and bottom decile are excluded from this range to produce a standard deviation which excludes exceptionals. (source: WM / BVCA, *Performance Measurement Survey 1999*).

<sup>31</sup> This is at the decile break-point.

**Figure 12.11: Range of returns in UK private equity funds, by investment stage**

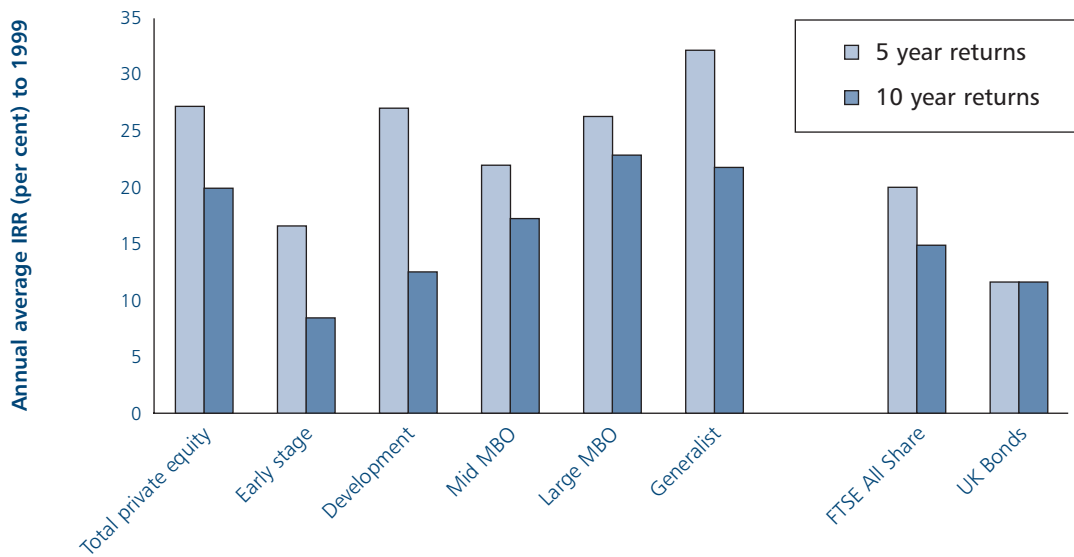


- 12.56 In general, the aggregate risk/return profile of mature funds (that is, funds at least 4 years old) has been more favourable for later-stage investments, particularly MBOs and larger funds. However individual funds have achieved impressive returns, irrespective of their investment focus or vintage year. This again underlines the importance of carefully selecting venture fund managers and presents a strong case for diversification when investing in private equity.
- 12.57 The cash-flow characteristics of investment returns to private equity tend to be very volatile when viewed from the perspective of an individual fund but are likely to be smoother and more predictable in a diversified private equity portfolio. Once an investor has committed funds, the general partners will typically draw down only some 80 to 95 per cent as and when required. As the limited partner receives returns when the private equity fund makes divestments, returns can vary considerably in size and be unpredictable in timing.
- 12.58 Generally, individual private equity funds produce positive net cash flows after three to five years; before this time, the money invested is illiquid. During the late 1990s, however, as investment returns have improved, many funds have been showing positive cash flows before three years. Typically this period will be shorter for buy-out funds than it is for early stage venture funds. Despite the initial illiquidity of specific private equity investments and erratic cash flows from individual funds, a well-constructed private equity fund portfolio has the potential to generate positive net cash flows over the medium term.
- 12.59 UK private equity did not perform well compared to other UK asset classes during the late 1980s and early 1990s. With the exception of 1987, the FTSE All-Share index outperformed annual private equity returns every year until 1993. However, from 1993 onwards, annual private equity returns have generally outperformed the FTSE All-Share. This has enabled the cumulative returns to private equity to catch up with public equity markets. In 1998, the cumulative average annual returns to private equity exceeded the cumulative average annual returns to the FTSE All-Share index for the first time (using 1987 as a base year).<sup>32</sup> This gap in performance has become more pronounced following the performance of private equity over the past two years. Ten-year annual returns from the FTSE All-Share currently stand at 14.9 per cent compared to 20.0 per cent for total private equity.<sup>33</sup>

<sup>32</sup> Oliver Burgel, *UK Venture Capital and Private Equity as an Asset Class for Institutional Investors*, London Business School, 2000. The result quoted uses 1987 as a base year, as in Burgel's report.

<sup>33</sup> BVCA / WM Performance Measurement Survey 1999

**Figure 12.2: UK Private equity returns and principal comparators**



Source: BVCA Performance Measurement Survey 1999

12.60 In the US, the private equity market, and in particular the venture capital market, has performed substantially better over the past two decades than UK markets. While there is less difference in returns now, UK venture capital returns lagged substantially behind those in the US during the 1980s and early 1990s. The overall net annual internal rate of return of the private equity industry in the US has been 17.6 per cent over the past 20 years.<sup>34</sup> Over this time, buy-out funds have posted the highest annualised returns at 19.3 per cent, while early stage venture funds have generated annual returns of 18.9 per cent.

12.61 Over shorter-term periods, however, although buy-out funds in the US have performed on average at around 17 per cent per year, early stage venture capital funds have produced outstanding results, giving annual internal rates of return of 47.9 per cent and 46.6 per cent over three and five years respectively. Balanced and later stage venture funds have produced annual returns of around 30 per cent over three and five years. The average annual returns from all types of venture capital are 33.7 per cent and 35.2 per cent for three and five years respectively.

**Table 12.2: US Private equity returns by investment stage – net IRR per cent per year, up to September 1999**

Fund Type	1 year	3 year	5 year	10 year
Early / Seed	91.2	47.9	46.6	24.5
Balanced	50.2	28.2	30.1	18.5
Later stage	55.5	28.4	34.8	25.4
All venture	62.5	33.7	35.2	20.8
Buy-out funds	15.2	16.6	16.7	16.7
Mezzanine debt	15.3	9.5	10.6	10.6
All private equity	28.7	22.3	22.7	18.4

Source: NVCA Yearbook 2000

12.62 Although over a 20-year timeframe US total private equity returns have outperformed UK private equity, over a ten-year timeframe the opposite is true. In the UK, ten-year annual rates of return are 160 basis points<sup>35</sup> above the equivalent returns in the US.<sup>36</sup> UK buy-out funds (both large and mid-sized) have consistently outperformed their US equivalents, especially over three, five and ten-year time frames. Over a five-year period, UK large and mid-sized

<sup>34</sup> NVCA Yearbook 2000, prepared by Venture Economics.

<sup>35</sup> One basis point is equal to one hundredth of a percentage point, that is 0.01 per cent.

<sup>36</sup> Using a comparison of WM / BVCA and NVCA data for the UK and US respectively.

MBOs had annual rates of return of 26.4 per cent and 22.1 per cent per year respectively, compared with an overall rate of return of 16.7 per cent achieved by US buy-out funds.

12.63 However, UK venture capital has substantially underperformed relative to US venture capital. In particular, early stage returns, which have led the way in the US, have been the laggard of UK private equity. Ten-year annualised returns to early stage investments in the UK of 8.7 per cent compare poorly with returns of 24.5 per cent for the same period in the US.<sup>37</sup>

## Private equity: sources of investment

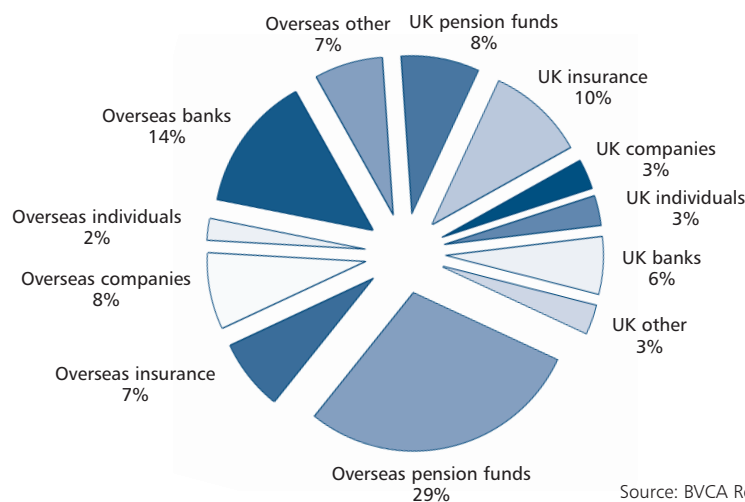
12.64 There has been a remarkable increase in the absolute levels of UK private equity funding since the mid 1990s. Independent UK funds raised £5.8 billion in 1999, compared with £749 million just four years before.

12.65 Overseas investors have been the key driver behind this growth, accounting for 70 per cent of the funds raised in the UK in 1999 by BVCA members. Analysed by type of institution, overseas pension funds committed the most, contributing some 30 per cent of the overall UK private equity market. They were followed by overseas banks (14 per cent) and UK insurance companies (9 per cent).

12.66 Up until 1996, when the UK private equity market was significantly smaller in scale, UK institutions provided the majority of investment in UK-managed private equity funds, representing 57 per cent of the funds raised in 1996. Of the 1996 total, UK pension funds were the leading investor, providing 30 per cent of investment, while UK insurance companies committed 9 per cent.

12.67 Over the three years that followed, UK institutions' relative share fell dramatically as the industry expanded rapidly. Although UK institutions were increasing their absolute levels of investment in UK private equity, they were not doing so at the same rate as their foreign counterparts. For example, although UK corporations have increased the level of funds committed to private equity more than fourfold from 1995 to 1999, overseas corporations have multiplied their commitment to UK private equity by a factor of 25 over the same period. The proportion of UK-managed funds invested in the UK has declined slightly from 84 to 79 per cent, while investment in continental Europe has risen from 14 to 18 per cent.

**Figure 12.13: Sources of investment in UK private equity, 1999**

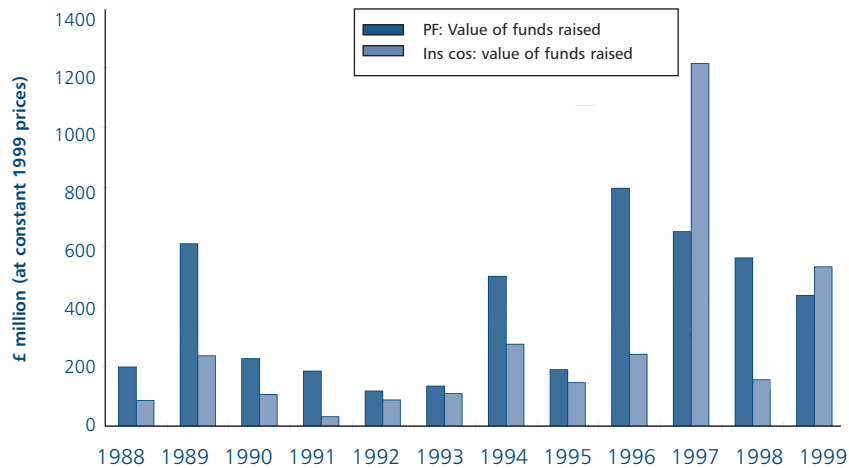


Source: BVCA Report on Investment Activity

<sup>37</sup> This ten-year period is up to end year 1999. Unless otherwise stated all data referring to investment horizons, that is, 3-year, 5-year or 10-year periods, are calculated up to the end of year 1999, the latest data available.

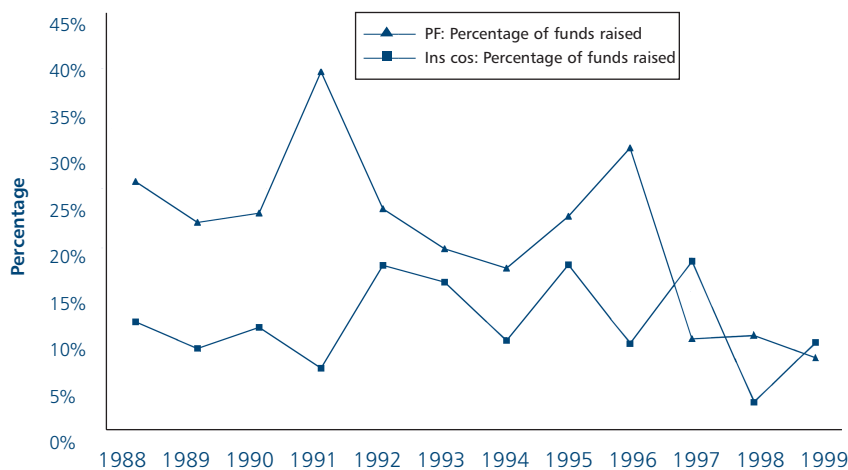
12.68 Moreover, UK pension funds have not only reduced their *relative* level of commitment but have also reduced their *absolute* level year-on-year for the past three years. While overseas pension funds' commitment in 1999 stood at 310 per cent of its 1996 level, UK pension funds in 1999 committed only some 60 per cent of the 1996 level. As with pension funds, UK insurance company investment also showed considerable volatility from year to year during the 1990s in terms of both absolute amounts and the percentage of funds raised. Commitments reached a record level of over £1 billion in 1997, but fell again to £152 million in 1998.<sup>38</sup>

**Figure 12.14a: UK pension fund and insurance company investment in UK private equity – value**



Source: BVCA Report on Investment Activity 1999

**Figure 12.14b: UK pension fund and insurance company investment in UK private equity – percentage**



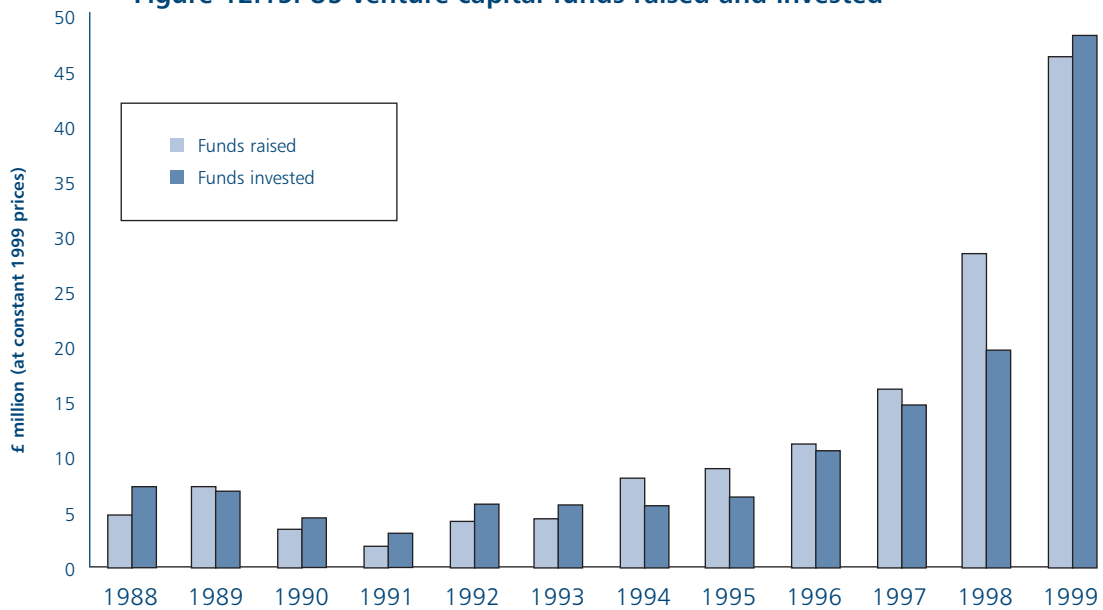
Source: BVCA Report on Investment Activity 1999

12.69 The US has witnessed a boom in fund-raising similar to the UK but on a much more substantial scale. From 1993 to 1999, annual commitments to US venture capital<sup>39</sup> multiplied more than tenfold to a total of \$46 billion.

<sup>38</sup> This volatility can probably be attributed to the fact that many insurers invest via semi-captive partnerships. Depending on whether or not these semi-captives raise new funds, the annual share of insurers' commitments to investments in venture capital fluctuates strongly.

<sup>39</sup> Figures in this paragraph relate to the level of *venture capital* commitments in the US, not *private equity*. The total funds raised for venture capital in the US in 1999, \$46 billion, is less than half the overall total raised for private equity in 1999, \$95 billion.

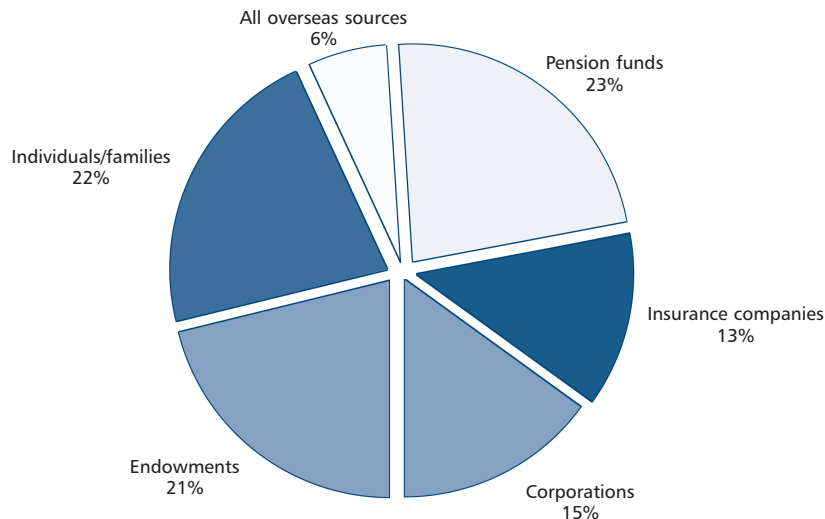
**Figure 12.15: US venture capital funds raised and invested**



Source: NVCA

12.70 Unlike the UK, only a fraction of this amount comes from overseas investors. US sources accounted for 94 per cent of US venture capital funds raised in 1999, while foreign investors were responsible for only 6 per cent of the total. Pension funds committed the most (23 per cent of the total raised), followed by individuals and families (22 per cent of the total, or \$10 billion). Endowment funds also committed substantial sums to venture capital (21 per cent of the 1999 total). In the same year, US insurance companies invested \$6 billion in US venture capital (13 per cent of the total).

**Figure 12.16: Sources of US venture capital, 1999**



Source: NVCA Yearbook 2000

12.71 Pension funds' role in recent decades as lead investors in US venture capital followed reforms to pension fund investment regulations (the so-called ERISA rules and guidelines) in the late 1970s. Endowments have also steadily committed more and more funds to venture capital over the past ten years. Yet the largest increase in both relative and absolute size of commitment has been from individuals and families, who very rapidly increased their contribution over the past two years, culminating in an overall contribution of \$10 billion in 1999.



- 12.72 While the absolute flow of investment from UK and US institutions into private equity and venture capital is clear, there is a continuing debate about the relative propensity of US and UK institutions to invest in private equity, as measured by the stock of such assets as a proportion of their total assets. It is widely held that US pension funds invest a significantly greater proportion of their assets in private equity than their UK counterparts. This assessment is supported by a number of surveys:
- The 1999 annual survey of members of the NAPF showed that 24 per cent of responding private sector schemes and 74 per cent of public sector schemes invested in private equity funds. Averaging the total reported private equity investment against the total assets of responding pension funds suggests that around 0.5 per cent of the assets of UK private pension funds are invested in private equity, while public sector pension funds invest around 0.8 per cent in this asset class.
  - Goldman Sachs and Frank Russell conduct a biennial survey of alternative investments by US pension funds and endowments. According to their latest survey (in 1999), and using comparable definitions to the UK, corporate pension funds allocated 6.6 per cent of total assets to private equity as a whole, and 1.3 per cent in the venture capital subgroup. Public sector pension funds in the US allocated 4.8 per cent to private equity, and 1.0 per cent to venture capital. The survey covers a wide sample of some 200 North American tax-exempt funds each with \$3 billion or more in defined benefit assets.<sup>40</sup>
- 12.73 Some important caveats must be borne in mind when attempting to draw conclusions from this general comparison of the level of investment of US and UK pension funds in private equity:
- US pension funds are typically much larger than UK pension funds. There are around 65 US funds with assets of over \$15 billion, but less than 15 UK funds of comparable size. Larger pension funds may have greater propensity to invest in private equity as they have more management resources at their disposal and a better capability to bear risk.
  - The US private equity market is much more mature than the UK private equity market and has demonstrated superior returns over time. It is therefore not surprising that US pension funds are more likely to invest in private equity than those in the UK.
- 12.74 Nevertheless, in light of all the evidence, the review considers that there is a substantive difference in the propensity of US pension funds to invest in private equity compared with their UK counterparts. US pension funds invest proportionately more in private equity as a whole, and also in venture capital as a subgroup.
- 12.75 As a particularly telling comment on the behaviour of UK pension funds, US pension funds invest more in the UK domestic private equity market than UK pension funds. Indeed, while the private equity market has been experiencing a period of unparalleled expansion and increasingly impressive returns, UK pension funds have reduced the absolute value of their commitment to private equity while US pension funds have more than tripled theirs. While this may in part be attributable to insufficient focus on marketing to UK institutions by UK private equity firms, that is not a sufficient explanation. The following section considers drivers and barriers to investment in UK private equity.

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<sup>40</sup> A number of biases may affect the results, however. Reporting is discretionary rather than mandatory and focuses on larger pension funds and endowments which tend to invest more actively in private equity.

# Drivers and barriers to UK institutions investing in private equity

## Drivers

- 12.76 Judicious investment in private equity has historically offered institutions the opportunity to obtain absolute levels of return significantly above those from other asset classes. This has particularly been the case in the UK over the last decade. For example, from 1992 up to 1998, cumulative annualised UK private equity returns (net of all management fees and carried interest) have outperformed UK public equities (FTSE All-Share) by a substantial margin of 910 basis points. Over the same time period, private equity also outperformed UK smaller companies (Hoare Govett index) by a margin of 1270 basis points, and UK index linked bonds by 1520 basis points.<sup>41</sup> Updating these figures using 1999 returns data,<sup>42</sup> the gap between UK private equity and UK public equity widens to approximately 1230 basis points. Private equity investment over early periods, though, showed a smaller positive margin. For example, from 1987 to 1998, UK private equity outperformed the FTSE All-Share annual rate of return by a margin of 20 basis points.
- 12.77 The margin that developed over public equity in the 1990s has largely been driven by sustained high average performance in UK MBO/MBI funds. Even higher absolute returns have been obtainable from US private equity, driven in that market more by the excellent performance of venture capital. Although institutions that invest in private equity devote only a relatively small fraction of their portfolio to this asset class, the extra absolute return that may be obtained means that private equity can make a material difference to overall fund performance. It therefore justifies the extra management effort and expense required.
- 12.78 Past performance is no guarantee of the future, however. Private equity tends to experience strong cycles in capital inflows, driven by the time lags between investment, financial returns and re-investment. These can in turn influence returns through competition on deal acquisition. The health of the public equity markets is also an important factor in realising private equity returns. However, the underlying 'technology' of private equity has proved robust over several decades in the US, and to a lesser degree the UK. Skilled and highly motivated private equity managers, given discretion over sector, stock selection and timing of investment, and able to play an active role in the strategic development of investee companies, have shown themselves capable of generating good returns over a medium-term horizon.
- 12.79 A stable macroeconomic environment also plays an important role in enabling growth in private equity funds and their underlying investee companies. It is likely that the greater stability in the US economy versus the UK over the past two decades contributed to the relative returns from private equity and venture capital. Volatility in market interest rates and consumer demand makes debt leveraged companies with narrow product ranges vulnerable to cyclical downturns. The UK's improved macroeconomic management in recent years, and the institutional reforms supporting this, should provide a good basis for future investment in real growth of UK businesses.
- 12.80 As a complement to macroeconomic stability, the Government also has a role to play in creating a favourable business climate for enterprises to start and to grow. Much of the success of the US venture capital industry can be attributed to the fertile entrepreneurial environment around clusters of universities and larger corporates on the West and East Coasts. This has made it much easier for venture capitalists to back enterprises with growth

<sup>41</sup> Source: Oliver Burgel, *UK Venture Capital and Private Equity as an Asset Class for Institutional Investors*, London Business School, 2000.

<sup>42</sup> Source: BVCA/WMM, Performance Measurement Survey 1999.

prospects. The US has also benefited from a more vibrant 'business angel' market, investing in and mentoring smaller growth firms, as an invaluable complement to formal venture capital investment.<sup>43</sup>

- 12.81 The UK Government has made substantial progress towards improving the climate for business angel investing and early-stage venture capital. Measures include targeted reductions in capital gains tax, tax-advantaged share option plans for smaller enterprises, and proposals to reduce barriers to communication between companies, venture funds and potential angel investors. The Small Business Service is also co-financing the creation of a network of commercially run venture funds across the UK. Like the SBIC programme in the US, these are aimed at 'equity gap' investments, below the level at which venture funds typically invest.
- 12.82 The review welcomes these changes, both actual and proposed. **The review further recommends that the Government continues to strengthen its programme of public-private venture fund partnerships, with the aim of filling gaps in the regional and technology venture capital markets. The review also recommends that as the venture capital market evolves, the Government keeps under close review the impact of its tax and regulatory measures in this area.**
- 12.83 The second force driving private equity investment has been pursuit of a diversified investment approach. Private equity managers are very strongly incentivised to achieve absolute returns over a fixed period of time. This contrasts with the incentives facing most fund managers in the public equity markets: for instance, to achieve top quartile performance relative to their peer group or to outperform a specific market index. Private equity offers institutions a partial hedge against this approach to investment. The other aspect which historically has attracted some institutions is the potential diversification of private equity returns with respect to quoted equity markets. In practice, however, the cycle of private equity returns has tended to track that of public equity markets.
- 12.84 The third driver to private equity investment – and particularly venture capital – is the more fundamental economic rationale that it provides access to emerging trends in 'new economy' sectors. The information flows from venture capital investments can help institutions understand developments in corporate sectors that may be under-represented in their public equity portfolios and can provide early indications of future trends in venture-backed IPOs. As private equity develops in the UK, it is likely that there will be a growing diversity of funds specialising by sector and investment theme, which will enable investors to choose more selectively those economic activities and trends to which they wish to gain exposure.

## **Barriers**

- 12.85 Respondents to the review have identified a number of specific barriers to private equity investment by UK institutions above and beyond the broader points it makes about institutional investment generally. Concern about some of these barriers may appear overstated. Nevertheless, to the extent that decision-makers in pension funds and insurance companies are conscious of them, they have a material impact on UK institutions' approach to private equity. The review has analysed barriers to investment under five headings:
- perception of UK private equity performance;
  - quality of performance information;

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<sup>43</sup> See, for example, Sohl, 'The early-stage equity market in the USA' *Venture Capital Journal*, 1999; and Mason and Harrison's many articles on angel investing in the UK.

- independent information sources;
- costs of private equity investment; and
- regulatory constraints.

## **Perceptions of UK private equity performance**

12.86 The poor historical performance of UK venture capital during the 1980s and early 1990s has cast a long shadow over UK institutions' attitude to private equity as a whole. This is despite improving recent returns to UK venture capital, and fairly consistently good returns to UK MBO funds. Disappointed by previous promises from the UK private equity industry, some major pension funds and influential pension fund managers exhibit a degree of scepticism about the ability of private equity to deliver on its potential. The lack of clarity in public discussion about private equity has not helped to market private equity to institutions either, and too little distinction is made between the different profiles of larger MBO funds and early-stage 'classic' venture capital. The UK trade association, the BVCA, has done much to educate potential investors but it could perhaps have been more effective during the 1990s in bridging this understanding gap, illustrated by the comments to the review from one institution:

*'We were always very wary of private equity because the whole asset class and all of its characteristics were completely alien to us. None of the names were familiar, we had no idea if the performance data was credible, the fee structure seemed expensive and opaque and we had no way of comparing one firm against another.'*

12.87 The review considers that there is need for greater clarity in public debate about private equity and the key differences between venture capital and management buy-outs. This may help dispel misconceptions among institutions about the varied nature of private equity investment in different sub-sectors of the market. **The review recommends that the BVCA increase its efforts to educate potential investors, the media, Government and Parliament about the role and economic contribution of private equity in general and about the differing characteristics of the various subsectors within it. This should support the long-term health of the UK private equity market, through better understanding among UK institutional investors, and should complement the marketing and raising of capital from overseas sources.**

## **Quality of performance information**

12.88 Second, even when individual UK-based private equity funds have generated good returns, UK institutions remain sceptical about the quality and coverage of UK performance data. There is no comprehensive, readily accessible and independently audited reporting on the absolute performance of UK private equity funds. This makes it difficult for potential investors to judge whether marketing claims are justified, on both the absolute performance of a private equity manager's previous funds and their relative performance against funds of similar vintage and sector. Many review respondents raised this issue:

*'I have never met a private equity manager who has not claimed that their returns are in the top quartile of the industry.'*

*'Performance data needs to have more detail, the categories are far too broad at present. Although early stage investments get a bad name, many generalist funds contain early stage investments that are the best performing parts of their portfolio. Until there is more detail it is impossible to compare like with like.'*

*'Performance data gathered on a voluntary basis, with no mandatory auditing and reported in aggregate for the whole industry, definitely does not reflect the kind of professional industry that the BVCA likes to portray.'*

- 12.89 The review considers that the industry needs to improve its self-regulation of the quality of information supplied about private equity performance. This is necessary to overcome considerable mistrust on the part of many UK institutions. There are two aspects to this issue: valuation of individual investments, and calculation of returns for individual funds. On the first point, the BVCA has made substantial progress in the 1990s towards establishing and disseminating guidelines on the valuation of individual private equity investments. **The review recommends that the BVCA should continue an active dialogue with the UK institutional investor community to educate investors about the validity of valuation techniques and to respond to any emerging concerns about the use, non-use or abuse of the BVCA's own guidelines.**
- 12.90 On the second point, many institutions reported concern to the review that some private equity managers may misrepresent their past performance to potential new investors by reporting only a flattering selection of previous individual investments. Such a practice has the potential to discredit much of the information flow from the private equity industry. **The review recommends that the BVCA establish and disseminate guidelines on the comprehensive – and independently audited – valuation of all investments made by private equity funds, where firms later use those valuations for marketing and/or fund-raising purposes. In preparing the guidelines, the BVCA should actively consult those UK institutions currently investing in private equity.**

### ***Independent information sources***

- 12.91 The third barrier to private equity investment by institutions (at least historically) is the lack of a specialist independent intermediary sector to help overcome such information and credibility gaps. Firms in this field should enable pension and insurance funds to move from a low level of understanding of private equity, through an analysis of whether it is appropriate for the particular fund's investment objectives, towards an asset allocation decision. If the fund then opts for private equity investment, the firm should help it to establish and implement a long-term strategy for selecting and investing in a portfolio of private equity funds. But to date, the structure of advisory and fund management contracts operated by many pension funds tended to produce generalist mandates. These give little incentive for actuarial consultants or equity fund managers to develop the skills necessary to specialise in private equity. In addition to fully independent and competent advisers, private equity fund of funds managers can also play a role in translating an institution's general intention to invest in private equity into a properly researched and managed programme. Fund of funds managers appear to have played an important role in the US market in educating potential institutional investors about private equity investment and providing access to the market.
- 12.92 A particular information gap concerns the lack of robust and detailed benchmark data by which to compare past performance of one private equity fund against its peers in the same sector and of the same vintage. In the US venture capital market, specialist data firms provide such information. In the UK, the WM Company produces an annual performance measurement survey in conjunction with the BVCA and Westport Private Equity, based on the returns of BVCA members. The voluntary and unaudited nature of these returns has led some institutions to question the validity of the results, which may show an upward bias if poor fund returns are not fully reported. There are also concerns about whether existing performance data is detailed enough to compare returns from a particular fund against those of competitor funds. **The review recommends that the BVCA enhance the**

quality and credibility of the industry benchmark data by further increasing coverage among its UK private equity member firms from the current level of 95 per cent, and introducing some degree of independent auditing of reported returns. As the market for private equity increasingly develops along European lines, the review recommends that BVCA work closely with the European Venture Capital Association to produce comparably accurate, detailed and credible performance data for European private equity funds as a whole.

### ***Costs of private equity investment***

- 12.93 Fourth, many institutional investment decision-makers share strong concerns about the costs of investing in private equity. UK institutions in practice appear to exert little influence over the key 'carried interest' parameter affecting the split of fund returns between investors and the private equity firm. Leverage is stronger over new entrants' first-time funds, but this may not be relevant for many UK institutions seeking their first exposure to private equity. There are also concerns about the opacity (to the institutional investor) and flexibility (for the private equity manager) of other aspects of the remuneration contract. Although remuneration should be irrelevant provided net returns are good (and indeed, aggressive incentives to capital growth are an essential part of private equity's 'technology'), the approach of the UK private equity industry to explaining its proposed remuneration terms has not inspired confidence among UK institutions.
- 12.94 Contract terms are – and should remain – primarily a bilateral issue for resolution between investors and managers, and their respective advisers. There is, however, a role for centrally provided information and guidance to enable first-time and smaller investors to enter the market more easily. **The review recommends that the BVCA, in consultation with established UK institutional investors in private equity, should encourage greater transparency among its members about contract terms. As part of this, it should produce comprehensive guidance for institutional investors about the full range of potential parameters in private equity contracts and their impact on net returns to investors. The review strongly supports healthy competition between private equity firms on all the parameters in remuneration contracts, and believes that the recommended approach should encourage this by strengthening the hand of investors.**

### ***Regulatory constraints***

- 12.95 Finally, regulatory constraints on private equity investment (in both life insurance companies and pension funds), allied to the cultural and organisational context in which institutions take asset allocation decisions, have tended to crowd out serious consideration of private equity. The particular aspects of regulatory constraints that impinge on private equity investment are discussed below. The MFR appeared as one of the main concerns of many pension funds considering private equity investment:

*'There is no doubt that the Minimum Funding Requirement influenced our discussions on private equity. Although it may not have been a direct factor in any decision it certainly set the scene in which decisions were made.'*

*'Although the MFR may not restrict you from investing in private equity completely it definitely does not encourage you to consider it as an option.'*

- 12.96 The review's proposals on the MFR are set out in Chapter 8.

## ***Authorisation to invest in private equity limited partnerships***

- 12.97 Under s191 of the Financial Services Act 1986 (and the proposed regulations under the Financial Services and Markets Act 2000, which will supersede it), the decision by a pension fund trustee board to invest in a particular limited partnership may be deemed to be investment activity for the purposes of the Act. In this case, the trustees must either become authorised to engage in investment activity, or they must appoint an authorised person to act on their behalf. Many larger pension funds have gone down either or both of these routes. For others, however, the extra legal uncertainty and cost of compliance can act as a barrier to private equity investment, compared with a similar decision to commit part of the pension fund's assets to a public equity market fund manager. Several interviewees raised this issue with the review.
- 12.98 The economic substance of the investment decision and the investor protection issues raised are little different from those affecting any other asset class. The review therefore considers that the effective requirement for trustees to be authorised under the Financial Services Act before they can invest in private equity partnerships is an unnecessary regulatory obstacle.
- 12.99 **The review recommended, in its interim report, that the Government should modify the regulation implementing the Financial Services and Markets Act, so that where an investment is made in a limited partnership solely for the purpose of investing that money onward in private equity investments, it is exempt from the prohibition in the Act on unauthorised persons engaging in investment activity.**<sup>44</sup>

## ***Life insurance companies: taxation of private equity limited partnerships***

- 12.100 The current taxation basis of life insurance companies' private equity investment via limited partnerships creates an excessive regulatory burden on such investment. This is because limited partnerships are transparent for tax purposes: partners, including life offices, are taxed on their individual share of the income and gains of the underlying assets. Any change in the partnership can trigger a tax liability, even though no cash gain has been realised. This can cause tax compliance problems, as often the managers of these partnerships are unable to provide the required information. The administrative burden tends to fall on the life office and is often disproportionate to the value of the investment. This is particularly so for smaller and medium-sized life funds and for investment via funds of funds. This fiscal compliance cost therefore bears most heavily on institutions likely to invest in independent private equity funds via limited partnerships (rather than developing their own in-house investment capability), and on fund of funds vehicles more suited to smaller institutions seeking some private equity exposure.
- 12.101 **The review recommends that the Government should legislate to change the taxation of capital gains on insurance companies' limited partnership investments by moving from taxation based on capital gains at partnership level (involving complex calculations and valuations) to taxation of the gains as distributed from the fund.** This would preserve the tax transparency of the limited partnership as an investment vehicle for insurance companies, and would maintain the total tax ultimately raised by the Exchequer from such insurance company investments. It would have the effect of postponing slightly the point at which some insurance companies pay tax. These complex cash-flow implications may give rise to small costs for the Exchequer.

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<sup>44</sup> The Government accepted this recommendation in the 2000 Pre-Budget report.

## ***Life insurance company investment limits and valuations***

12.102 FSA rules for 'with-profits' life funds specify that no more than 1 per cent of assets should be invested in a single unquoted security (such as a limited partner interest in a private equity limited partnership) and that unquoted securities in total should comprise no more than 10 per cent of total assets. These limits do not in practice impinge on most decision-making by life funds when considering private equity investments, because of other drivers limiting the exposure of life offices to this asset class. This is examined further in Chapter 9, where the review also recommends that the 10 per cent limit should be kept under review.

## ***Limited partnership application to private equity***

12.103 The UK private equity industry adopted the limited partnership as a legal structure after its successful use in the development of the US private equity business. The UK legal basis for limited partnerships (the Limited Partnership Act 1907) shares many of the advantages of the US regime, but also has a number of specific disadvantages. These stem largely from the use of a generic and rather archaic piece of legislation. The most serious drawback for institutional investors in private equity limited partnerships is the uncertain legal status of limited partners engaged in overseeing investment activity. This is often a requirement for institutions, but there are concerns among private equity lawyers that such activity may be deemed to be management of the limited partnership, which could expose institutions to legal risk. The other drawback of UK limited partnerships is the 20-partner limit: in the US the limit is 500. Private equity funds often need to establish parallel partnerships at some legal cost in order to take investments from more than 20 investors. So the current legal restriction serves only to raise business costs without in practice adhering to the obscure historical rationale for a 20-partner limit.

12.104 **The review recommends that the Government considers changes to the law affecting limited partnerships to increase significantly the maximum number of partners per partnership (from the current limit of 20), and to remove the legal uncertainty on the ability of institutional investors to participate in an investment advisory/oversight role for the partnership, without jeopardising their status as limited partners. This should encourage the use of investment advisory boards as an effective means of facilitating institutional oversight of funds and improving accountability and communication.** The Law Commission is currently undertaking a review of Partnership Law as a whole, which provides an opportunity to consider such changes.

## ***Financial services regulation***

12.105 The UK private equity industry has grown and flourished as the gateway to the European market in part because of the UK's generally supportive regulatory environment. This regulatory regime is in a process of transition, as the new Financial Services and Markets Act comes into force this year and the Financial Services Authority (FSA) rulebook replaces the Investment Management Regulatory Organisation rulebook. At the same time, the private equity industry is becoming more international in outlook, in both its fund-raising and investment activities, with the result that the overlay of different national regulatory regimes can create barriers to business efficiency. Private equity investment has expanded significantly in recent years and has the prospect of continuing to do so over the coming decade in Europe, as continental pensions move to a funded basis and constraints on institutional investment in private equity reduce.



12.106 In the light of these developments, it is important that the FSA should build on its experience of regulating the UK private equity industry by responding sensitively to future market developments. Private equity investment is a distinct activity, of growing significance in both financial markets and the real economy. It undoubtedly benefits from a distinctive regulatory approach in areas such as compliance with conduct of business rules, investment promotion, and capital adequacy requirements. To achieve these regulatory objectives, **the review recommends that the FSA establish a centre of expertise on private equity investment business.** This should provide a natural conduit for discussions with the private equity industry about its evolution and the regulatory issues this raises. This recommendation would reinforce the FSA's own objective to bear in mind 'the international character of financial services and markets and the desirability of maintaining the competitive position of the UK'. Given the recent growth in funds under management in private equity, and the prospect of the UK continuing to be the major 'gateway' for private equity investment across Europe as a whole, the review considers that such an investment in capacity by the FSA would be most beneficial. As private equity grows in Europe, the UK has an opportunity to build on its current base of skills and experience by capturing a larger share of this growing market.

## Conclusion

12.107 Private equity has certain features that make it a difficult asset class for institutional investors: its illiquidity, the difficulty of pricing it quickly and easily on a market, and the complexity and importance of sources of advantage in the industry. The UK industry also raises some specific issues: notably a history of mixed returns. But the willingness of US institutions to invest in UK private equity provides a striking contrast to the relative reluctance of UK institutions to invest in those same opportunities. The review believes that the opportunity exists for UK institutions to consider private equity more actively than they have done in the past. It believes that its broader proposals, especially the principles in Chapter 11, will have a significant and positive impact on decision-making about the asset class. In addition, it has made a series of recommendations specific to private equity:

- **that the Government continues to strengthen its programme of public-private venture fund partnerships, with the aim of filling gaps in the regional and technology venture capital markets. The review also recommends that as the venture capital market evolves, the Government keeps under close review the impact of its tax and regulatory measures in this area;**
- **that the BVCA increase its efforts to educate potential investors, the media, Government and Parliament about the role and economic contribution of private equity in general and about the differing characteristics of the various subsectors within it. This should support the long-term health of the UK private equity market, through better understanding among UK institutional investors, and should complement the marketing and raising of capital from overseas sources;**
- **that the BVCA should continue an active dialogue with the UK institutional investor community to educate investors about the validity of valuation techniques and to respond to any emerging concerns about the use, non-use or abuse of the BVCA's own guidelines;**

- that the BVCA establish and disseminate guidelines on the comprehensive – and independently audited – valuation of all investments made by private equity funds, where firms later use those valuations for marketing and/or fund-raising purposes. In preparing the guidelines, the BVCA should actively consult those UK institutions currently investing in private equity;
- that the BVCA enhance the quality and credibility of the industry benchmark data by further increasing coverage among its UK private equity member firms from the current level of 95 per cent, and introducing some degree of independent auditing of reported returns. As the market for private equity increasingly develops along European lines, the review recommends that BVCA work closely with the European Venture Capital Association to produce comparably accurate, detailed and credible performance data for European private equity funds as a whole;
- that the BVCA, in consultation with established UK institutional investors in private equity, should encourage greater transparency among its members about contract terms. As part of this, it should produce comprehensive guidance for institutional investors about the full range of potential parameters in private equity contracts and their impact on net returns to investors. The review strongly supports healthy competition between private equity firms on all the parameters in remuneration contracts, and believes that the recommended approach should encourage this by strengthening the hand of investors;
- as recommended in its interim report, that the Government should modify the regulation implementing the Financial Services and Markets Act, so that where an investment is made in a limited partnership solely for the purpose of investing that money onward in private equity investments, it is exempt from the prohibition in the Act on unauthorised persons engaging in investment activity;
- that the Government should legislate to change the taxation of capital gains on insurance companies' limited partnership investments by moving from taxation based on capital gains at partnership level (involving complex calculations and valuations) to taxation of the gains as distributed from the fund;
- that the Government should consider change to the law affecting limited partnerships to increase significantly the maximum number of partners per partnership (from the current limit of 20), and to remove the legal uncertainty on the ability of institutional investors to participate in an investment advisory/oversight role for the partnership, without jeopardising their status as limited partners. This should encourage the use of advisory boards as an effective means of facilitating institutional oversight of funds and improving accountability and communication; and
- that the FSA establish a centre of expertise on private equity investment business.

# APPENDIX A: Pension fund trustee survey

## Survey methodology

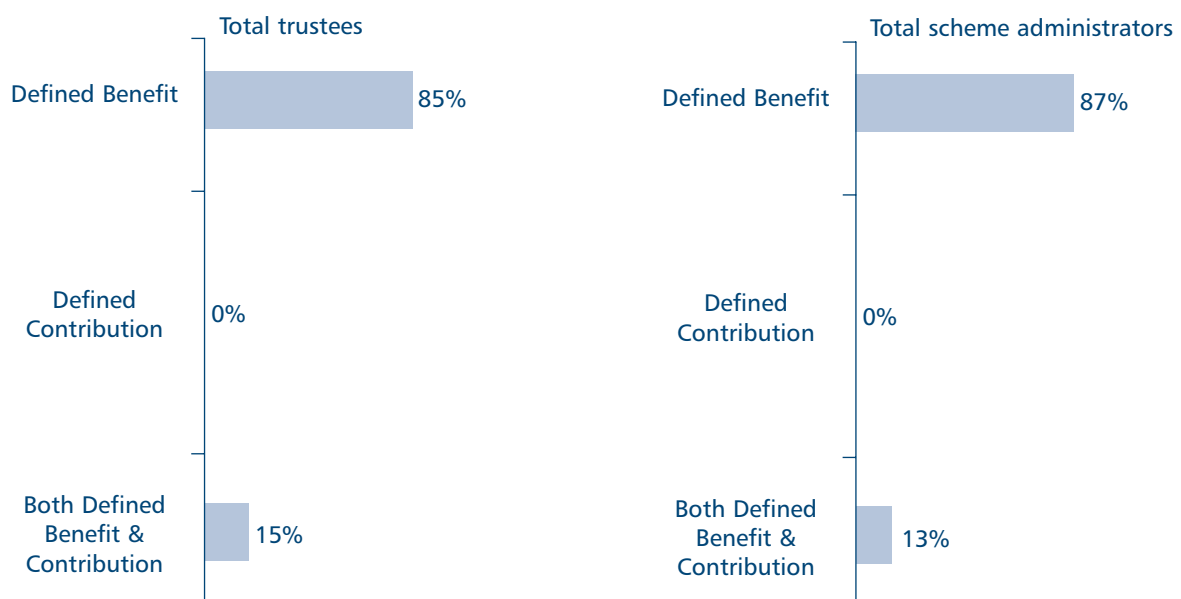
- A1. This Appendix details the findings of the research conducted among trustees and scheme administrators on behalf of the review with the assistance of the National Association of Pension Funds (NAPF). A total of 301 respondents were interviewed: of these 226 were trustees; 75 were scheme administrators; and a total of 122 funds were represented.
- A2. Of the 226 trustees, 75 represented funds of less than £100 million, 75 represented funds of £100-£399 million, and 76 represented funds of £400 million or more. A number of the very largest funds were specifically excluded on the grounds that they represented a fourth category of super-large schemes which could not be meaningfully analysed using market research of this sort: the Coal Industry Pension Schemes, Post Office Pension Plan, British Telecommunications plc, Electricity Supply Pension Scheme, Universities Superannuation Scheme, and the Railways Pension Fund.
- A3. Interviews were conducted by telephone by Taylor Nelson Sofres, on behalf of Incite Marketing Planning Limited. Each interview lasted a maximum of 25 minutes, using a fully structured questionnaire. Interviews were conducted between September and October 2000.
- A4. The research was set up and analysed by Incite Marketing Planning Limited.
- A5. There were no significant differences in the results when comparing the different fund sizes. As a result the analysis focused on the total sample.

## Main research findings

### *Financial investment experience and training*

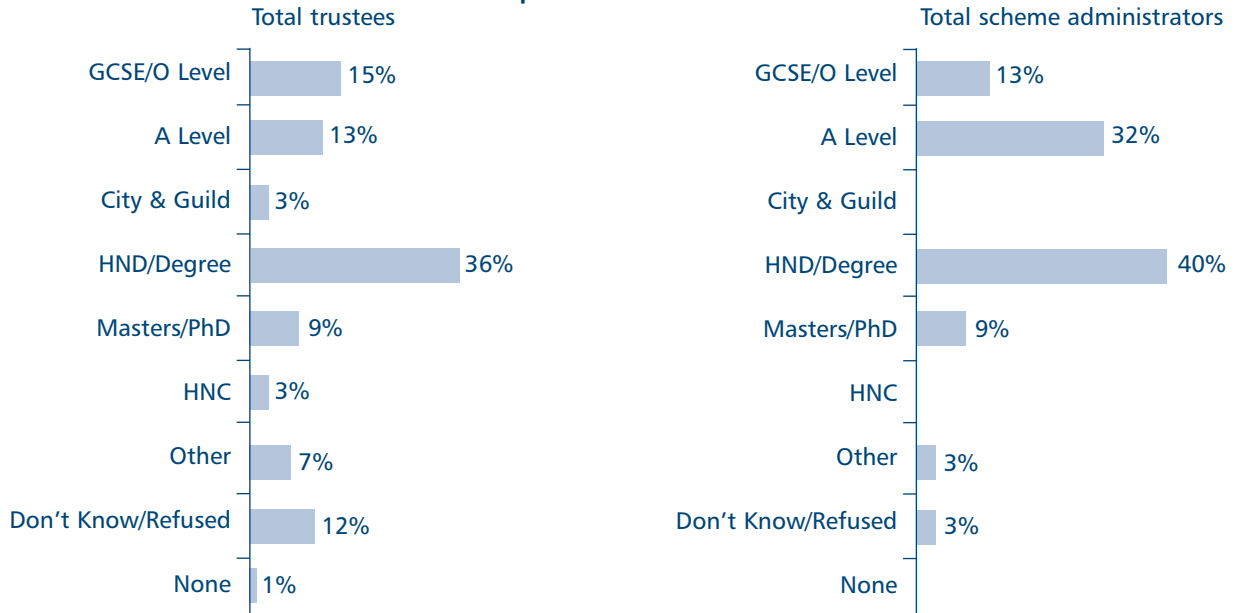
- A6. The majority of respondents were involved with defined benefit schemes: 85 per cent of trustees and 87 per cent of scheme administrators.

#### Q3 – Is your company's pension scheme...



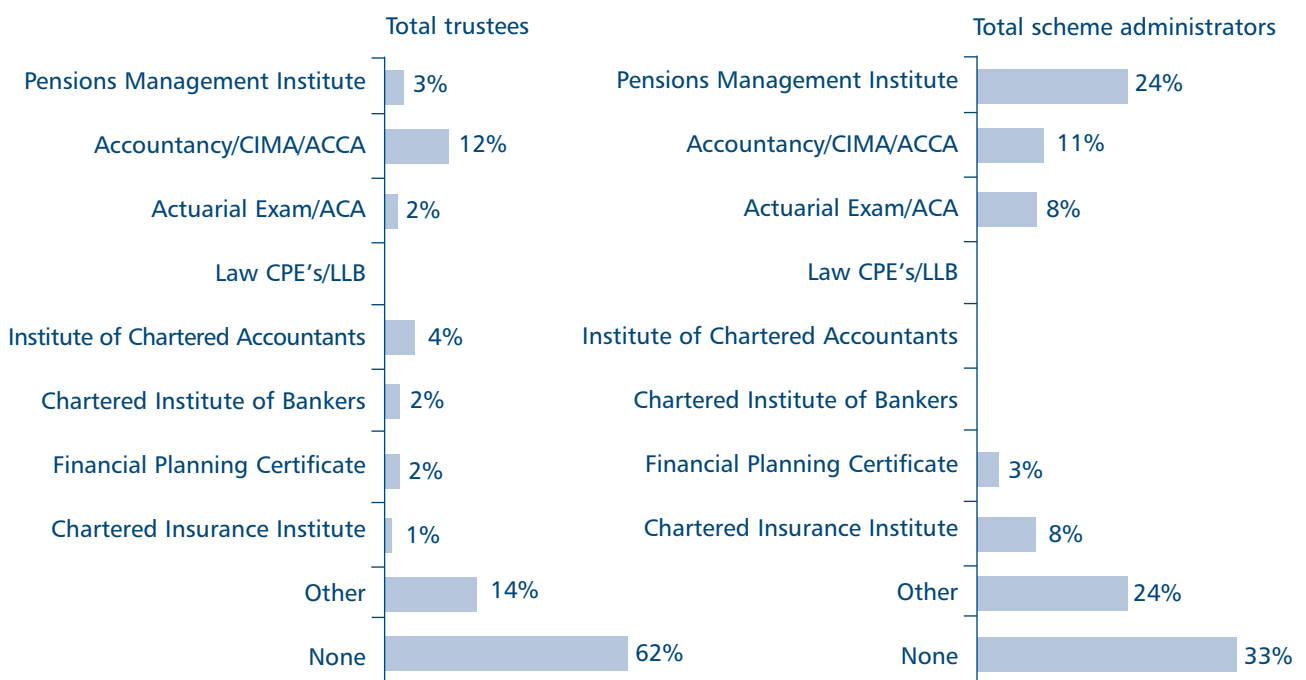
A7. One in every three trustees had a HND/degree level education or above, although almost as many did not.<sup>1</sup>

**Q11 – What was the furthest level of qualifications you received, other than professional qualifications?**



A8. The majority of trustees have no professional qualifications in finance/investment, whereas scheme administrators appear to be more qualified in this area. Of those trustees who do have a relevant qualification Accountancy/CIMA/ACCA are most popular. Among scheme administrators the Pensions Management Institute is the most common qualification.

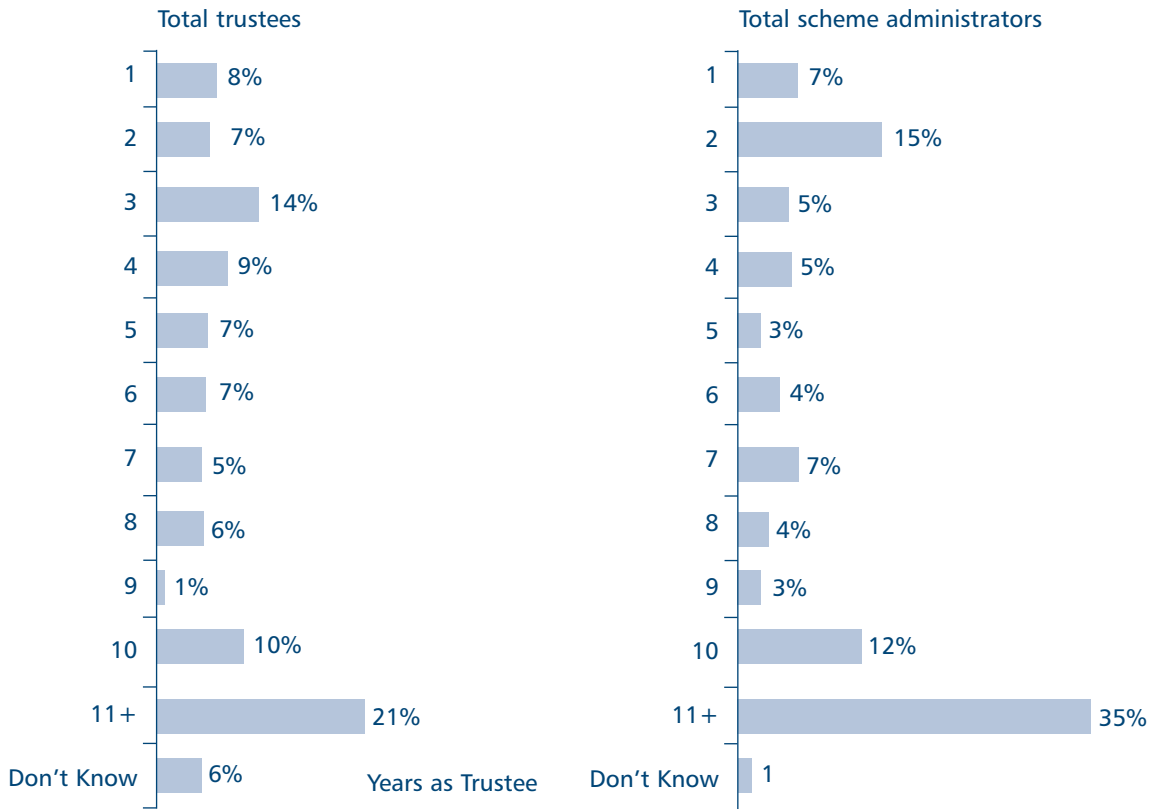
**Q12 – What professional qualifications do you have in finance/investment?**



<sup>1</sup> The level of 'don't know' response is typical for a sample of this nature when being interviewed about a professional role.

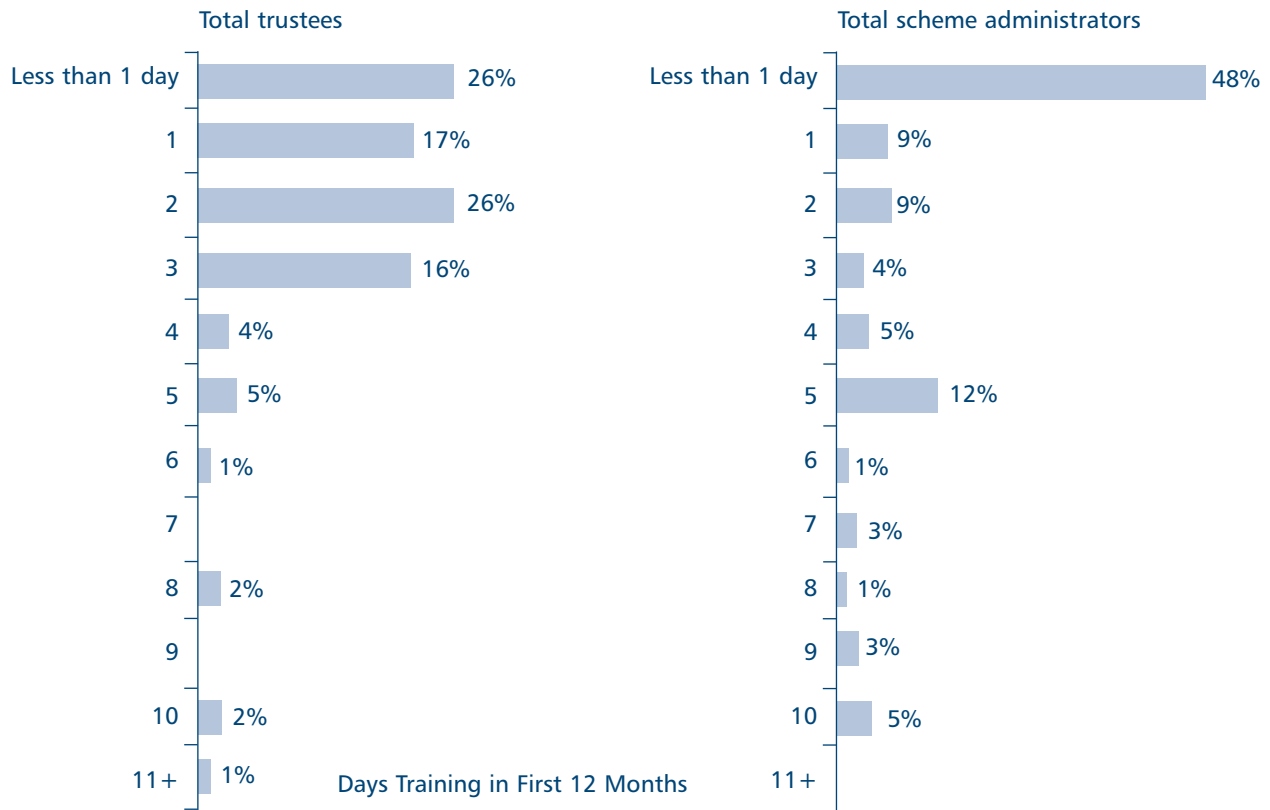
A9. The range of years of experience among trustees and scheme administrators varied considerably. Of the trustees interviewed, 15 per cent have fewer than three years' experience, whilst 31 per cent have 10 or more years. Among scheme administrators, 22 per cent have fewer than three years' experience, 47 per cent 10 or more years.

**Q13 – How long have you been a trustee?**



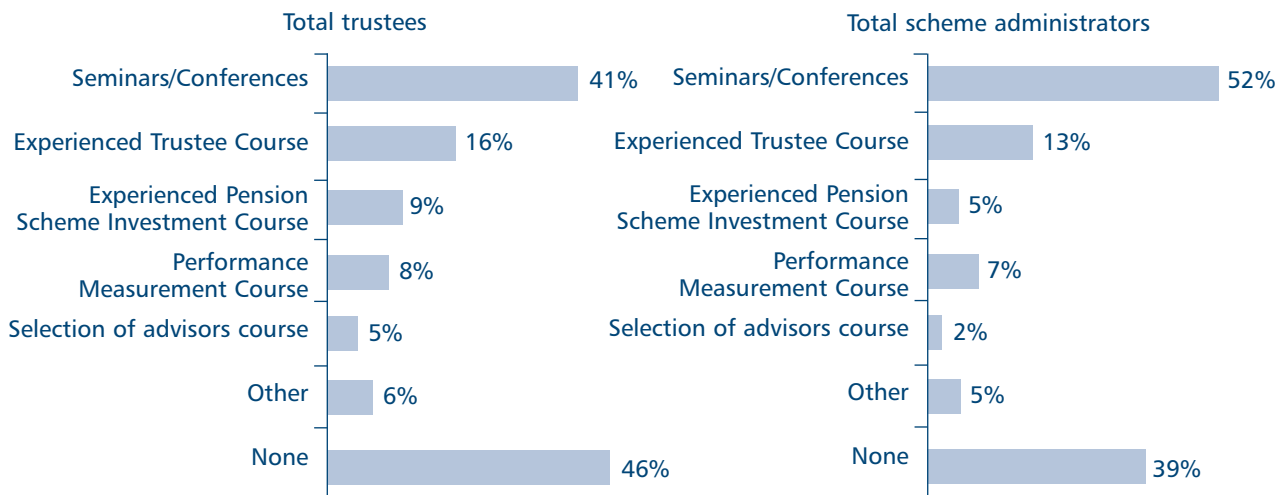
A10. In the first 12 months of trusteeship, 26 per cent of trustees received less than one day's training, and 43 per cent of trustees received one or two days training. 48 per cent of scheme administrators have received less than one day of training.

**Q14 – How many days, in total, of training did you receive when you first became a trustee (first 12 months)?**



A11. Of the training courses on offer, the most popular course for trustees in their first 12 months is the basic trustee course, provided by the NAPF, followed by courses provided by consultants. Among scheme administrators the NAPF course is also most popular.

**Q16 – Which further courses if any relevant to your role did you attend?**



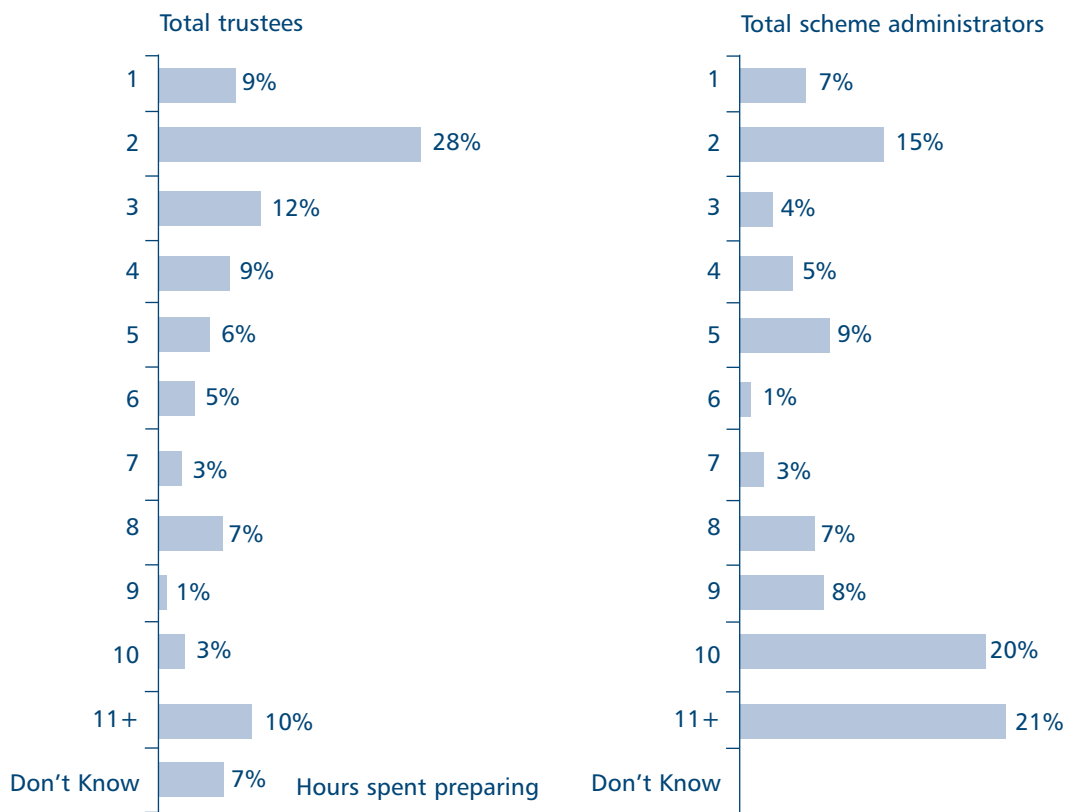
A12. Further training, beyond the initial 12-month period, is limited and appears to focus on conferences and seminars: 46 per cent of trustees interviewed reported to have received no training beyond the first 12 months.

***Involvement of trustees and administrators***

A13. The majority of trustees and scheme administrators held full-time jobs (79 per cent and 87 per cent respectively).

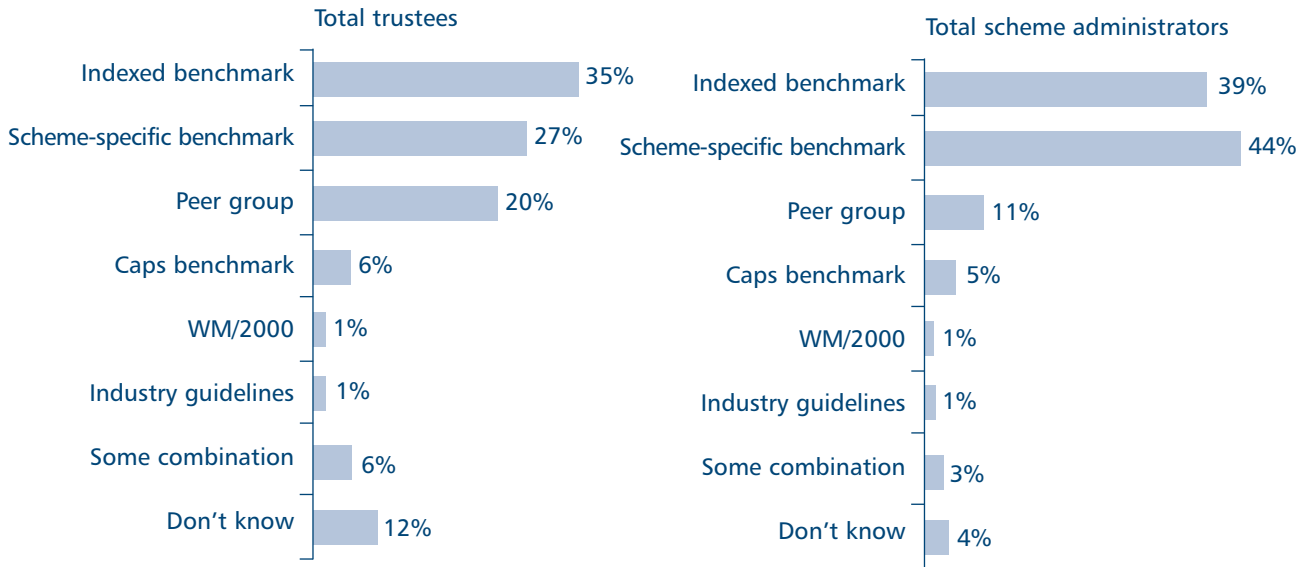
A14. 49 per cent of trustees spent three hours or less preparing for pension investment matters.

**Q24 – How many hours, if any, do you personally spend preparing for pension investment matters?**



A15. Indexed and scheme-specific benchmarks are referenced by the majority of funds. There is, however, a difference of opinion between trustees and scheme administrators regarding the nature of the benchmarks used, even when respondents are from the same funds. Scheme administrators are more likely to reference indexed and scheme-specific benchmarks than are trustees, 20 per cent of whom reference peer group benchmarks.

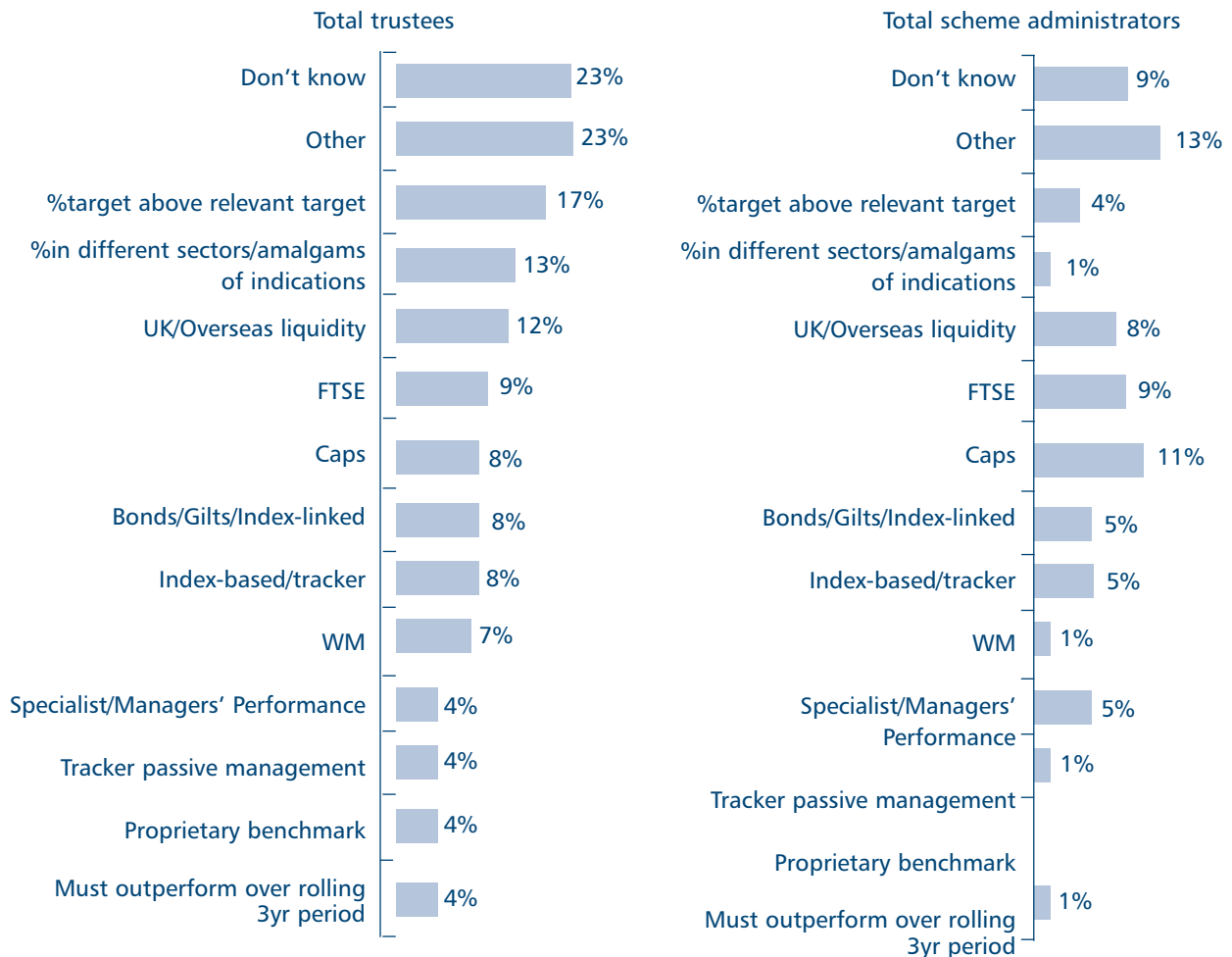
**Q9 – What type of benchmark does your pension scheme use?**





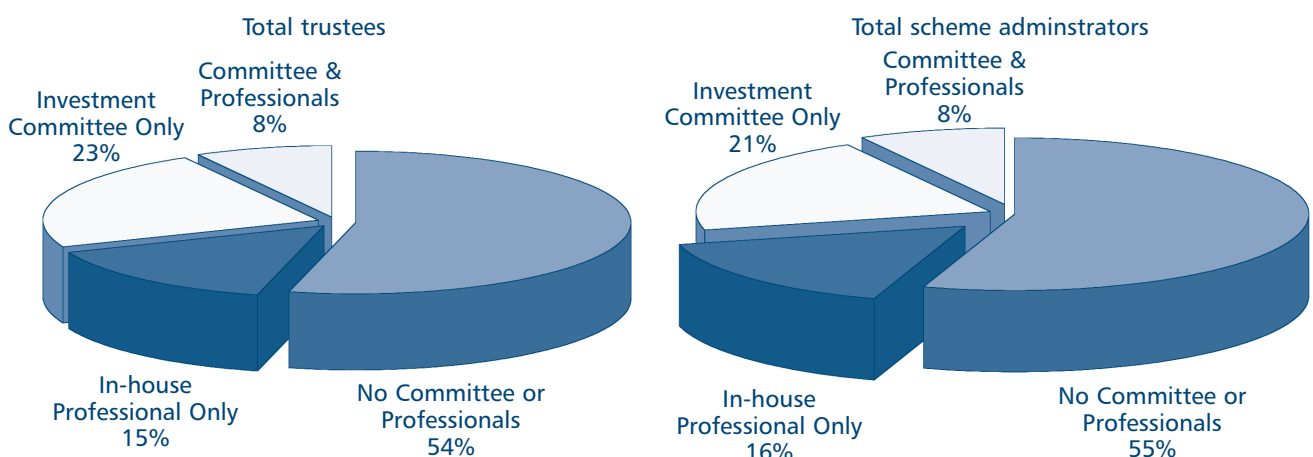
A16. Among those who noted scheme specific benchmarks the trustees listed 'per cent target above relevant target' as the most popular. Among scheme administrators their responses were more varied, with 'CAPS', 'FTSE', and 'UK/Overseas liquidity' as the benchmarks mentioned most often.

**Q10 – (All mentioning scheme-specific benchmark) What is the benchmark?**



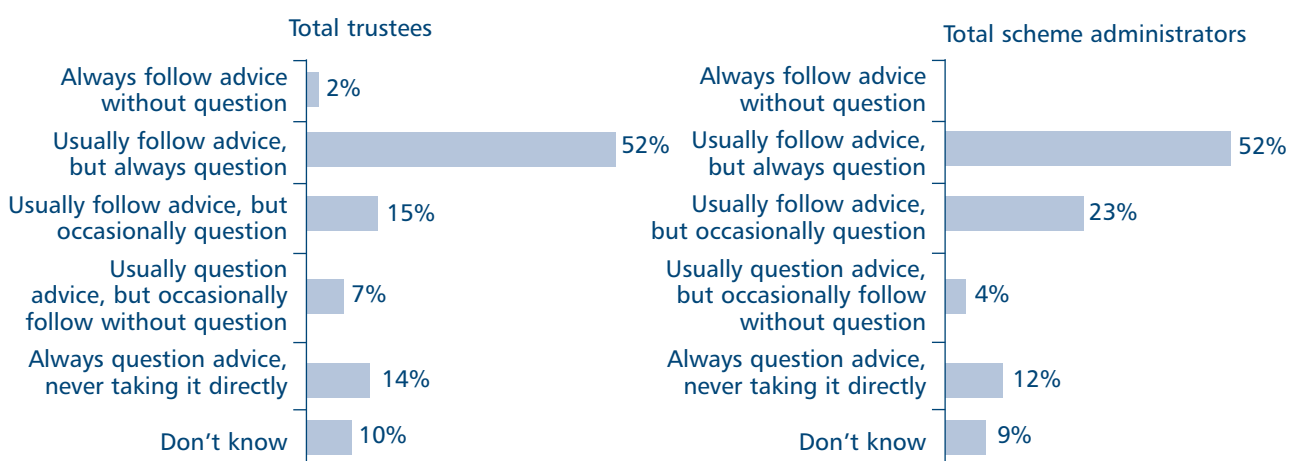
A17. The majority of funds do not have a separate investment committee or in-house professionals.

**Q4 – Does your company's pension scheme have a separate investment committee?  
Q30 – Does your pension scheme have in-house investment professionals?**



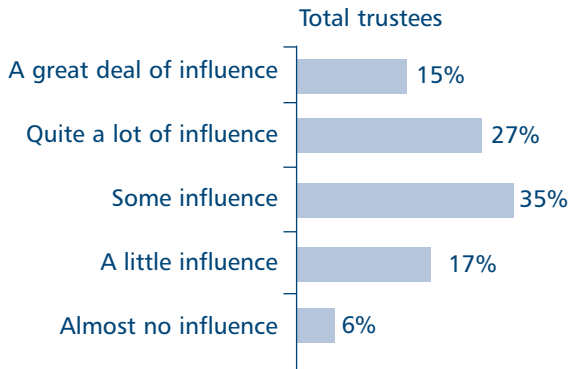
- A18. Almost two-thirds of trustees have one investment consultant to work with – very few funds having more than one available (58 per cent of trustees stated they only worked with one investment consultant, and a further 13 per cent stated they did not know). 76 per cent of scheme administrators stated they used only one investment consultant, with six per cent stating they did not know.
- A19. Even when investment managers are available, trustees have limited contact with them – 54 per cent speak to investment managers less than once every three months. Trustees do not have the opportunity to spend time with investment managers either - 61 per cent spending time with managers less often than every three months.
- A20. Scheme administrators are more likely to be involved with investment managers, with 44 per cent speaking to investment managers at least once a month, and 56 per cent spending time with investment managers at least once every three months.
- A21. There is a difference of opinion among trustees and scheme administrators with regard to the frequency with which trustee boards question consultants’ advice. A quarter of trustees reported that their boards have questioned advice within the last month, whereas only 12 per cent of scheme administrators agreed with this.
- A22. This difference of opinion continues in relation to the degree to which advice is followed. When asked how much they agreed with the statement ‘we follow the advice of investment consultants’, 21 per cent of trustees strongly agreed, compared with 37 per cent of scheme administrators.
- A23. Almost all trustees reported to question the advice given by consultants, although most usually followed the advice given.

**Q32 – Which of these statements best describes how you personally react to advice provided by investments consultants?**

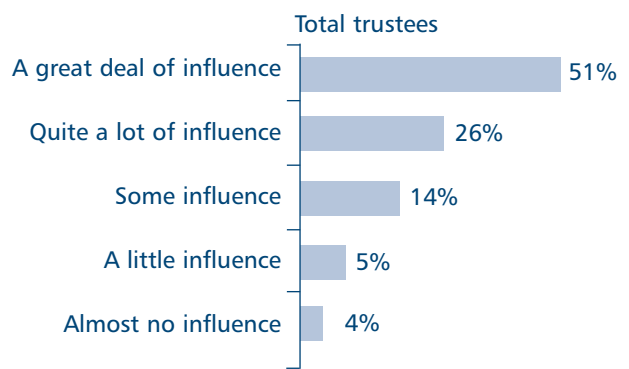


- A24. The degree to which trustees feel they have influence over strategic asset allocation differs depending on whether that influence is at a collective or personal level. Collectively, trustees clearly feel their influence is strong, whilst individually they feel they have some influence.

**Q21 – How much influence would you say you personally have over the strategic asset allocation decisions of your pension scheme?**

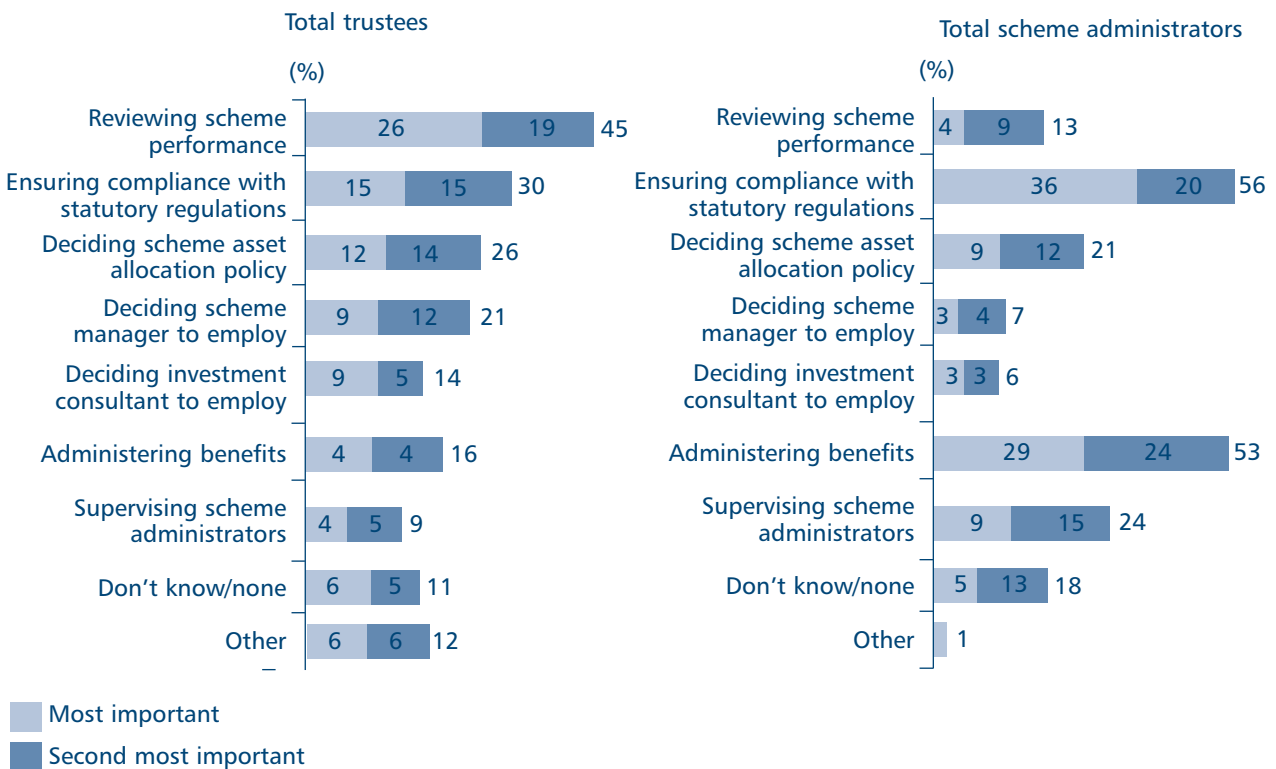


**Q22 – How much influence would you say the trustees collectively have over the strategic asset allocation decisions of your pension scheme?**



A25. Trustees are involved in a number of tasks relating to pension funds with the most common being the review of the scheme performance, and ensuring compliance with statutory regulations. When asked to prioritise the importance they place on these tasks, it is clear that performance review is seen as the most important task, whereas compliance with regulations, and asset allocation, are somewhat secondary.

**Q18 – Which of these do you think is the most important task you are involved in?  
Q19 – Which is the second most important task you are involved in?**



A26. Trustees and scheme administrators held a range of opinions relating to investment strategies.

	Trustees Agreeing %	Scheme Administrators Agreeing %
The fewer active members and the more the deferred members and pensioners in our scheme, the less we should invest in equities	58	69
The financial strength or weakness of our sponsoring company should have no impact on our investment policy	55	48
The fewer active members and the more deferred members and pensioners in our scheme, the less we should invest overseas	19	20
Pension schemes with large sponsoring companies can make a riskier investment than schemes with small sponsors	26	36
The more risky the asset, the more likely it is to earn a high return	54	55
The best way to minimise risk for the pension scheme is to avoid equity investment and stick to bonds and gilts	28	21
The most serious risk for a pension scheme is that it does less well than other pension schemes	8	9
It is safer to invest some money overseas than to have all of it invested in the UK	70	81
The best way to minimize risk is to invest in index tracking schemes	28	27
The best way to assess scheme manager performance is to measure how a manager has done against the UK stock market	33	31
The primary reason for investing in venture capital / private equity is to reduce risk	8	7
The best way to guard against inflation is for the pension scheme to buy more index-linked gilts	32	29
Forecasts of UK interest rates over the next year should not have any significant impact on our investment strategy	43	51
The primary reason for investing in venture capital / private equity is to increase return	75	73

A27. Most investment consulting and management contracts appeared to be last tendered more than three years ago.

**Q34 – When did your pension scheme last tender an investment consulting contract?**



**Q40 – When did you last tender your investment management contract?**



## APPENDIX B:

# Local Authority Pensions

### Introduction

B1. The Local Government Pension Scheme (LGPS) is a final year, defined benefit, statutory scheme covering all local authorities in England and Wales. The scheme is administered by 89 separate fund authorities at County Council, Unitary authority and London borough level. The type and level of benefits is determined by regulations made under section 7 of the Superannuation Act 1972. The funds are large, on average (see Table B.1 below) - often very large in relation to other pension schemes in the UK and abroad. Benefits are guaranteed by statute with local taxpayers being the final guarantors. Parallel arrangements exist in Scotland and Northern Ireland.

**Table B.1: Local authority universe: size analysis**

	Average value £m	Median value £m
WM Local Authorities	1,000	641
WM All Funds	335	51
WM 50	5,931	3,900
WM 2000	138	47

Source: The WM Company

- B2. In 1998/9 total scheme membership was 2.6 million of which about half were pensioners and deferred members. Overall the scheme is relatively mature. In 1998/1999 it paid £3 billion in benefits and received £0.95 billion in employee contributions and £1.8 billion from employers. Investment income totalled £2.3bn from assets in excess of £68 billion.<sup>1</sup>
- B3. The scheme is contributory. All new members contribute 6 per cent of their salary, and employers' contributions are determined according to a triennial valuation by actuaries appointed by each fund authority. At present, employers are paying between 5-20 per cent of payroll.
- B4. The funds are not administered by trustees, but in its administration, a local authority is required to act in a quasi-trustee capacity. Investment decisions are typically made by a committee (or panel) made up of elected members, which meets, on average, about 4 times a year. The investment committee is supported by professional in-house staff, usually the Treasurer, and may also have external experts sitting on it - or a separate panel of experts may be consulted before decisions are made.
- B5. All local authority pension funds are to be subject to a Best Value Review in the next five years, which will require all funds to approach their work as though they were businesses - with business plans, setting out their strategic objectives, and annual operating plans. It will also require them to have more stringent audit trails.

<sup>1</sup> Information provided by the Local Government Pension Division of the Department of Environment, Transport & the Regions (DETR).

## Investment Strategy

- B6. A number of external factors can impact on the investment strategies adopted by individual fund authorities. For example, they were permitted to drop below 100 per cent funding under the previous Government, but are now required to ensure solvency by the Scheme regulations. Local authority pension funds are not subject to the Minimum Funding Requirement.
- B7. A number of respondents to the review argued that local authorities are relatively risk averse in their investment stance - one pointed to a 'prevailing ethos of risk aversion', for example. Others said:
- 'One overriding feature of Local Authority Funds is that as depositories of public money they have reason to be more risk averse than their private sector counterparts.'*
- 'Relative risk aversion has encouraged the use of balanced managers and a peer group benchmark.'*
- B8. In fact, asset allocation for local authority funds is strikingly similar to that for pension funds as a whole - and their performance over 10 years has been very similar (see Tables B.2 and B.3 below).

**Table B.2: Asset allocation comparison as at 31st December 1989 and 1999 for All Fund and WM 50 and at 31st March for Local Authority funds**

Asset class	All Fund		WM 50		Local Authority	
	1989 %	1999 %	1989 %	1999 %	1989 %	2000 %
<b>Overseas equities</b>						
UK	53	51	51	48	55	50.6
Overseas	21	24	19	25	22	22.3
<b>Fixed interest</b>						
UK	6	8	7	8	6	6.9
Overseas	2	4	1	3	2	4.8
<b>Index Linked</b>						
UK	2	5	3	6	2	5.0
Overseas						
<b>Property</b>	10	4	13	6	6	4.6
<b>Cash/other</b>	6	4	5	4	7	5.7
	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

Source: The WM Company

**Table B.3: Investment performance for local authority funds v all funds, 1989-99  
(per cent per annum)**

	<b>Local Authorities</b>	<b>All Funds</b>
UK equities	14.8	15.0
Overseas equities	12.9	12.7
UK bonds	11.4	12.8
Overseas bonds	8.6	9.1
Index-linked	10.1	10.0
Cash/other	8.1	8.5
Total ex-property	13.3	13.6
Property	8.0	7.7
Total assets	13.0	13.1

Source: The WM Company

B9. However:

- a number of local authorities do not use an investment consultant to assist them in fund manager selection. A number of funds are managed in-house (with some minor specialist mandates);
- two-thirds of the externally managed funds have a balanced management structure, with most choosing only one or two managers;
- according to The Society of London Treasurers, in 1997, five fund managers held mandates for about 65 per cent of all externally managed LGPS assets and three firms of consulting actuaries were retained by over 95 per cent of fund authorities, very often also acting as investment consultant; and
- peer group benchmarks continue to be the predominant comparator for most Local Authority Funds (see Table B.4 below). Almost half choose the WM Local Authority peer group, with a further 25 per cent comparing themselves to the WM All Funds or the WM 2000 Universe.

**Table B.4: Local Authority benchmarks**

<b>Benchmark used</b>	
Universe benchmark	69
WM 50	0
WM Funds	10
WM 2000	12
WM Local Authority	47
Customised	23

Source: The WM Company

B10. The level of index tracking in local authority funds remains lower than for pension funds generally.

- B11. A number of local authority funds responding to the review's consultation document said that they had an allocation to private equity, with some of them targeting such investments in order to try to help their local economy.

## Regulatory framework on investments

- B12. The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 and 1999 (made under the Superannuation Act 1972) impose a regulatory framework on investments by LGPS fund authorities.
- B13. Since July 2000, local authorities have been required to prepare and publish Statements of Investment Policy. The wording in the regulation requiring a SIP follows that contained in the Pensions Act 1995.
- B14. The provisions of the 1998 Regulations require fund authorities to invest any fund money that is not needed immediately to make payments from the fund. For this purpose, 'investment' is given its normal meaning although the regulations go on to exclude certain types of instruments which may normally be regarded as investments and include others which might fall outside. In formulating their investment policy, a fund authority must have regard to diversification and to the suitability of particular investments and types of investments and must obtain proper advice at reasonable intervals about their investments. Only fund managers, authorised under the Financial Services Act 1986 (and in the future, the Financial Services and Markets Act 2000) may be granted delegated responsibility to manage and invest LGPS funds. However, the statutory responsibility rests with the designated elected members of the relevant local authority.
- B15. Schedule I of the 1998 Regulations imposes certain prudential limits on particular types of investment. There is a 1 per cent limit on any single sub-underwriting contract; a 2 per cent limit on all contributions to a single partnership; a 5 per cent limit on all contributions to partnerships; a 10 per cent limit on investment in unlisted securities of companies, deposits with a single bank, institution or person (and other limits); a 15 per cent limit on all sub-underwriting contracts and a 25 per cent limit on all investments in units or other shares of unit trusts managed by one body and open-ended investment companies where the collective schemes are managed by any one body; all insurance contracts; and all securities transferred (or agreed to be transferred) by the authority under stock lending arrangements.<sup>2</sup> There is no firm evidence to suggest that these prudential benchmarks hinder the investment performance of LGPS funds.

**The review recommends that these limits, particularly those relating to investment in limited partnerships, should be kept under review by DETR.**

- B16. Consultation is currently in train to review DETR's stewardship of the 1998 Regulations and to assess their current effectiveness and operation. Views are also being sought on how improvements in the level of participation by interested parties in the investment process could be achieved.

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<sup>2</sup> The Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998. S.I. 1998/1831. The explanatory note attached to the Regulations indicates that the changes of substance are the inclusion, as investments, of insurance contracts, sub-underwriting and oeics. Local authority pension funds are also restricted in the amount that they can invest in employer-related investments (1996 Regulations S.I. 1996/3127).



## Conclusions

B17. The review has not identified any issues specific to local authority funds. At the same time, it has also not found any reasons to suppose that the broader analysis in the report does not apply. Clearly, given local authorities' greater use of peer group benchmarks and reduced use of consultants, some parts of the analysis are of greater importance than others. But the main conclusions apply. By that logic, the review's recommendations, where relevant, should therefore also apply to local authorities.

**The review recommends that local authorities should disclose their compliance or otherwise with the principles set out in Chapter 11. Other relevant recommendations are:**

- **the recommendation that scheme rules, SIPs or fund managers' mandates should not other than with good reason prohibit the use of particular instruments such as derivatives or prohibit investment in certain asset classes;**
- **the recommendation that sponsor companies (in this case, local authorities) should ensure that trustees have sufficient in-house staff to support them in their investment responsibilities;**
- **the recommendation that all funds should incorporate the US Department of Labor principles on activism into fund management mandates. It also recommends that the principles should in due course be more clearly incorporated into UK law.**
- **the recommendation on the MFR. The review recommends that the Government should consider to what extent the proposals it has made to replace the MFR should be applicable to local authorities, including the proposal for mandatory independent custody.**