



A statement on the financial crisis by The Local Authority Pension Fund Forum

Introduction

According to many serious commentators, the world is facing the most severe economic disruption since the Great Depression. Although the centre of the crisis is focused on the financial sector and markets, the result is that the real economy is facing significant problems, with unemployment already steadily increasing.

Whilst a number of linked factors had led to the crisis, such as cheap credit, mispricing of risk, inflated asset prices and ineffective regulation, it is clear that proper governance, and the role of investors in promoting it, is an important strand. As an organization with approaching 20 years' experience of shareholder activism on corporate governance and social responsibility issues, the Local Authority Pension Fund Forum (LAPFF) believes it has a unique investor perspective on the financial crisis.

Whilst the Forum appreciates the necessary management strategies that the boards of troubled financial institutions are having to undertake as a result of the credit crunch and subsequent global financial market collapse, we consider it imperative that under these circumstances companies should be striving to maintain the highest standards of corporate governance.

In addition the Forum stresses the need for a step-change in standards of personal ethical behaviour in the financial sector. In order for markets, and society in general, to function effectively trust is a vital ingredient. Yet the public's trust in the financial sector, and senior figures within it, has been severely damaged by this crisis. Therefore the restoration of integrity to the financial sector must be a part of post-crisis reconstruction.

The Forum is releasing this public statement in order to set out its view of the financial market crisis, and its plan of action for the future.

Board competence and independence

The Forum believes that the primary responsibility for the failure of financial institutions must lie with the boards of those companies. Ultimately it was the boards which agreed to strategies which have seriously damaged the companies of which those directors were meant to be stewards. Therefore the initial focus of governance reform must be on significantly improving the quality of boards.

One challenge is to further strengthen the role of non-executives. In this regard the Forum believes that institutional shareholders must ensure that the non-executives on the boards of major financial institutions both have a credible background, including relevant qualifications as far as possible, and are properly supported. LAPFF also believes that a focus is required on the time that non-executives have available to perform their role and this must logically raise a question about individuals with multiple directorships. Inevitably institutional shareholders will also consider the role of directors at failed financial institutions in their assessment of those individuals' suitability on other companies' boards, now and in the future.

The Forum is also willing to explore the possibility suggested by the FSA of a requirement for directors to have regard to the need to promote and maintain systemic financial stability.

The concern that institutional shareholders must not let companies exploit the financial crisis to argue for a relaxation of compliance with the Combined Code is an important one for the Forum. Some companies may seek to argue that the current environment means that institutional shareholders need to give them more freedom to operate, even if this involves a breach of best practice. The Forum will seek to resist any such back-sliding. Good corporate governance is more important, not less, during this crisis, and investors must be willing to stand their ground.

Remuneration

Some of the problems experienced by leading financial institutions demonstrate why remuneration must remain a core governance issue for investors. A very narrow conception of incentive and reward has resulted in arrangements which encourage inappropriate short-term risk taking at the expense of long-term success. And we should acknowledge that institutional shareholders have sometimes inadvertently played a role in the promotion of such schemes, because they were wrongly thought to align the interests of management and shareholders.

In addition, the Forum believes that institutional shareholders must also ask fundamental questions about the absolute level of reward. For too long, continually rising executive remuneration, and the widening gap between

directors and other employees, has been treated as a somehow inevitable and therefore un-problematic feature of modern capitalism. All kinds of excuses have been put forward – sometimes by shareholders themselves – for why the status quo should not be challenged. First it was the need to attract the right people, then it was need to compete in the global market for executive talent, and more recently we were told executives needed more money to prevent them taking companies off the public markets with private equity. Each time the level of reward was ratcheted up, and each time too many investors acquiesced.

Yet it is now surely beyond doubt that paying an ever-increasing amount to directors does not correlate with business success, nor align companies' interests with those of their long-term institutional shareholders. Much of the increased expenditure on vastly inflated executive remuneration, in the banking sector primarily, but across boards in general, was simply a waste of shareholders' money. Something must change.

Historically LAPFF has sought to challenge companies over inappropriate remuneration arrangements. Our recent experience demonstrates that we need to redouble our efforts and, where necessary, lead the institutional shareholder moves for reform.

LAPFF also believes that in addition to addressing recent failures, institutional shareholders must be adopt a forward-looking agenda. Therefore in addition to ensuring that remuneration arrangements are structured in the best long-term interests of shareholders, LAPFF will also seek reform of executive pension arrangements, and greater linkage between rewards and management of non-financial issues.

Auditors

Reliable financial reporting is the lifeblood of capital markets. Investors must be able to rely on companies' audits, and auditors. The Forum's ongoing campaign in respect of audit has focused some attention on the reports produced by audit committees. At many companies LAPFF has found audit committee reporting is often formulaic and therefore unhelpful for shareholders. LAPFF will continue to push for better reporting.

However the Forum also acknowledges that this is often a complex area (particularly when dealing with financial institutions) and directors sitting on audit committees equally face real challenges on properly getting to grips with their own company business models. Therefore LAPFF consider there may be a case for appointing an independent adviser to a company audit committee whose role could include engaging with external auditors, developing agendas, providing technical briefing and recommending when a second opinion should be obtained.

Risk

More broadly, there must be a greater focus on risk by company audit committees. The Forum believes that there is a case that risk directors should have a separate and independent reporting line to audit committees and the board as a whole. Ironically, risk reporting by financial institutions is usually comprehensive, though we might question its effectiveness, but there is scope to improve risk reporting by non-financial companies, and by smaller businesses.

One reform option therefore might be to require companies to prepare a risk report as part of their audit committee report to shareholders, and that the audit committee report should be subject to an annual shareholder vote. In addition to encouraging reporting by non-financial companies, it would also encourage investors and their advisers to properly consider the risk disclosures made by companies before approving them.

The role of institutional shareholders

The role of institutional shareholders in the crisis is an issue that LAPFF considers to be of great importance. The Forum notes that organizations ranging from the UNPRI to the FSA have raised the question of whether investors have devoted sufficient attention and resources to ownership issues. LAPFF has throughout its history sought to ensure that companies are accountable to their owners and that they adhere to high standards of governance and social responsibility.

LAPFF shares the view that this is a time when institutional shareholders must sharpen their focus on governance issues and heed the call from Lord Myners to intensify their collective efforts. The Forum is therefore deeply concerned by reports that some asset management institutions are actually cutting back the resource that they devote to analysis of environmental, social and governance (ESG) issues. In our view this is completely the wrong thing to do, and can only damage clients' confidence that ESG factors are being given proper consideration. LAPFF intends to use the influence it has to encourage asset managers in particular to maintain and enhance their commitment to assessing corporate governance and social responsibility risks and opportunities.

Where we go from here

As an immediate priority, the Forum will be engaging with the UK's banks to understand both what has gone wrong and, more importantly, how they intend to address the myriad issues arising from the crisis. If necessary, LAPFF may put into action its newly-formulated structure for filing shareholder resolutions in order to focus investor pressure on governance issues of concern.

On governance policy, the Forum will seek the type of reform outlined above in relation to board competence and independence, remuneration, audit and risk. The Forum will seek to collaborate with other investors and other reform proponents wherever possible.

Finally, LAPFF intends to push further with its focus on the capabilities and competencies of fund managers in respect to ESG issues. It will carry out research into the role of fund managers in the run-up to the crisis, focusing particularly on voting and engagement activity.

May 2009