The Myners Review of Institutional Investment

for HM Treasury

May 2000

HM TREASURY

Institutional investment: a consultation paper

Foreword

The UK's capital markets have a crucial role to play in enabling enterprise, innovation and growth. Institutional investors are clearly key participants in these markets. Compared to many leading economies, our equity and venture capital markets are relatively larger and more developed. This should be a source of competitive strength for UK plc.

However, I have personally been concerned for some time that we may not be making the best possible use of this strategic asset. We have a large pool of long-term capital but do we invest it with a sufficiently long-term view? Have we as an industry become too risk-averse, concerned more about the risks of underperformance versus some benchmark, rather than the rewards of outperformance? Are we too prone to invest in established companies, rather than higher risk start-ups? Is the growth of indexation exacerbating a bias towards companies with large market capitalisations? Do the major institutions follow investment patterns that are too standard, seeking safety in numbers, rather than pioneering radically different investment strategies? Do we have the right incentives to tackle underperformance at the companies in which we invest? Do we have appropriate competencies at each key point in the investment decision making process?

So when the Chancellor asked me to lead an inquiry into these issues, I was delighted to accept. These are difficult questions. But they are critically important to the long-term health of the UK economy.

In my inquiry, I hope to explore in depth the factors that guide institutional decision-making. I am not seeking to explore the factors that drive entrepreneurship in the UK, a vitally important area. Clearly, if we are to invest more in entrepreneurial businesses, then there must be a strong supply of good new businesses into which we can invest. This is a major issue which the Government is rightly addressing, though it is of course outside the scope of this review.

Rather, I wish to focus on whether there are factors that are distorting decision-making by institutional investors. It is not appropriate for Government to second-guess institutions' investment decisions. But if there are structural factors that are distorting rational decision-making, then there may be a role for Government in helping to remove these distortions.

Such distortions could arise from many sources: from the way the industry measures and reports performance; from the incentive structures for each participant in the industry including professional advisers, fund managers and trustees; from the traditional ways the industry has made investment decisions; and from regulatory provisions, where there may be unintended side effects of government initiatives that are distorting decision making. I intend this review to throw new light on these issues, clarify whether there is a major problem here, and identify solutions.

This initial consultation document sets out some issues for discussion. I welcome all submissions and hope that a broad spectrum of organisations and individuals will respond. I will report to the Chancellor with recommendations in time for the next Budget.

I share the Chancellor's concern that there may be a problem here and that there may be factors encouraging institutional investors to follow industry-standard investment patterns. I am genuinely open-minded as to what the solutions might be. I hope that a constructive process of consultation and dialogue will help identify some practical and helpful recommendations.

Paul Myners

Responding to the review

Anyone wishing to respond to this consultation document should write to the secretary to the Review, Daniel Oppenheimer, at:

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This document can be found in full on the Treasury website:
htttp:\\www.hm-treasury.gov.uk

Responses are requested by Friday 14th July

Introduction

1. In the 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 SMEs and other smaller companies, and that a review would be set up to look at these issues.

2. The review will report back with recommendations by Budget 2001.

3. The purpose of this consultation document is to solicit views from all interested parties on the nature of the problem and its possible underlying causes.

Institutional Investment

4. UK institutional investors - primarily pension funds and life insurance companies - are key participants in UK equity markets, controlling around 45% of quoted equity investments. In general, UK institutional investment in equity markets has been a major success story enabling millions of pension scheme members and individual policy holders to benefit from stockmarket returns. At the same time, evidence suggests that institutional investment has focused almost exclusively on quoted equities and gilts (with insurance companies also investing quite substantially in corporate bonds). There appears to have been a reluctance to invest in other assets such as venture capital, companies outside the major indices and high-yield bonds.

- Though precise figures vary, UK pension funds typically invest about 0.5% of their assets in venture capital, where their US equivalents invest nearer ten times this portion - around 5%. UK life insurance companies invest comparably small proportions of their portfolios in venture capital. Moreover, venture capital investment is largely in more mature businesses, rather than in early-stage and start-up.

- In 1998 the UK venture capital industry raised less than 13% of its funds from UK pension funds and insurance companies; over 37% of its funding came from their foreign equivalents, almost three times the UK total.

- The UK corporate bond market, including high yield securities, is far less developed than in the US. There are many reasons for this, and there is now strong evidence of change and growth in these credit-based fixed income securities. However, they remain small markets by US standards.

- In recent years, more small companies have delisted from the London Stock Exchange than have joined it, and surveys of small company managements have shown high levels of dissatisfaction with the stock market.

5. These investment patterns may be cause for concern. It is important for growth and innovation that there is the broadest possible range of financing alternatives available, particularly for smaller companies, including manufacturing companies.

6. Any review of the issue must take account of issues raised by these asset classes themselves:

- Past returns for some of them have not always been good.
- There has not always been a strong supply of good investment opportunities, and supply has sometimes been concentrated on certain sectors. For example, most UK venture capital firms have tended to focus more on management buyouts than on early-stage or development capital.
- By their nature, smaller markets can be difficult for large investors to invest in because the market concerned cannot absorb the minimum scale of investment which is efficient for the investor.

Issues for discussion

i. To what extent do supply issues explain the relative underdevelopment of these markets?

ii. To what extent is investment in smaller asset classes discouraged by transaction costs and/or liquidity issues?

iii. Why is activity sometimes concentrated in certain subsectors, as in the case of UK venture capital?

7. Nonetheless, it is not obvious that these factors are the sole explanation for the current industry-standard patterns. Given the diversity of customers and beneficiaries being served by various investors, one could expect undistorted investment decisions to yield greater risk appetite in the aggregate than currently appears to be the case. There remains a concern that investment decision-making may be being distorted and hence that capital is being inefficiently allocated in the economy.

Views are invited on these observations and concerns.

Occupational Pension funds: Common Issues

8. At present, defined-benefit (DB) funds account for the majority of pension fund assets, though the share accounted for by defined-contribution (DC) funds is expected to increase steadily in future.

Corporate structure and objectives

9. DB schemes' structure and the legal and regulatory environment create a number of particular objectives for them:

- Delivering the "pensions promise" to their beneficiaries.
- In doing so, to minimise the long-term funding cost, particularly for the sponsoring employer.
- Ensuring stable levels of contributions, minimising the chance that the pension fund sponsor or contributing employees will have to make additional contributions beyond the long-term funding cost.

The balance of incentives suggests that DB pension funds may be likely to be more concerned by the threat of underperformance than the possibility of overperformance.

10. In theory, DC schemes have an objective of maximising benefits for their beneficiaries at a risk level appropriate to the circumstances and preferences of the members. In practice, do they tend to focus on the performance of the fund against benchmarks, with priority being placed on avoiding underperformance against the benchmark? The issue of benchmarks is considered later.

Issues for discussion

iv. Is this description of pension funds' objectives correct?

v. Do DC schemes invest differently to DB schemes (both at an individual level and also within each asset category)?

Increasing maturity

11. Pensioner liabilities are an increasingly significant proportion of funds' liabilities, with greater longevity and more early retirement. The traditional view has been that the assets covering such liabilities should be weighted towards low-

risk assets, since the liabilities will need to be covered in the short term. Other things being equal, therefore, increasing maturity of pension funds would lead them to invest less in higher-risk and non-standard asset classes. But this seems to be only part of the picture. In general, well-funded pension funds are less affected by increasing maturity. Moreover, for all pension funds, even less well funded ones, the fact that pensioners are living longer means that it seems less appropriate to view all pensioner liabilities as relatively short-term ones, since a portion of them will not crystallise for 20 years or more.

Issues for discussion

vi. To what extent can investment patterns be explained by the increasing maturity of pension funds? How does the use of insured "pension annuity" products amplify or reduce these effects?

Pension fund trustees

12. Pension fund trustees do not in general seem to be drawn from the ranks of those experienced in investment. Anecdotal evidence suggests that while some pension funds do have high quality training programs for trustees, many trustees receive little training. Moreover, most are employed, and in practice appear to have limited time to devote to their duties, which of course extend beyond simply investment decision making.

13. Given this, and given also pension funds' objectives as set out above, it seems reasonable that trustees' major concern is likely to be to avoid what they perceive as underperformance. With limited time and expertise available to meet this goal, one would expect them to rely heavily on professional advice and to feel most comfortable replicating the practices and decisions of others.

Issues for discussion

vii. Is this a valid description of the approach of a significant number of pension fund trustees?

viii. Does trust law provide an appropriate basis for pension scheme governance, particularly investment decisions? Can lessons be learnt from other countries' practices in this area?

Investment consultants

14. The above suggests that pension fund trustees may be reluctant to adopt non-standard investment strategies. This raises the question of whether the incentive structures encourage the investment consultants who advise the funds to recommend non-standard strategies. Two ways in which they could do this are:

* Afee structure which gave the consultants a financial interest in the risk-adjusted performance of the fund.
* Competitive pressure from other consultancies seeking to win the pension fund's business on the basis of their ability to deliver better performance.

15. Preliminary investigation suggests that these incentives apply relatively weakly. Investment consultants are not normally paid by fund results. Nor do competitive pressures appear to be particularly strong. Pension funds tend to use as their investment consultants the same firm which is providing wider pensions advice to the fund. It appears to be unusual for funds to change consultants. Furthermore, the investment consulting industry in the UK is fairly concentrated.

16. It is also becoming increasingly common for investment consultants to advise on asset allocation themselves, rather than leaving it to fund managers. The impact of this practice is not clear.

Issues for discussion

ix. What are the incentives, both commercial and regulatory, acting on investment consultants and the advice they give?

x. What is the impact on asset allocation of the practice of asset allocation decisions being taken by consultants?

xi. Is concentration of the investment consulting industry an issue?

Fund managers

17. The incentives on fund managers are asymmetric. Significant underperformance against benchmark is likely to lead to mandate termination, whereas significant outperformance merely qualifies the manager to compete for new appointments with others with similar performance records. Other things being equal, this asymmetry may create an incentive for fund managers to shadow their benchmark fairly closely. Such a strategy would minimise the risk of underperforming it by much, while still leaving open the possibility of outperforming it by

a small amount by varying investment strategy at the margin. Fund managers' strategies therefore seem likely to be influenced by the targets they are set and the benchmarks or indices against which they are measured (see below).

18. There are some other areas which seem worthy of further investigation:

* Success-related fees, which could help address the asymmetry of incentives, are still fairly unusual in the UK.
* There is significant concentration in the UK pension fund industry for the management of balanced multi-asset portfolios. The growing use of specialist manager appointments covering a single asset class or group is lessening the predominance of a small number of managers, as is the success of new foreign entrants.
* Portfolio decision-making is increasingly using risk management tools with the aim of limiting deviation from industry standard returns.

Issues for discussion

xii. Is the suggested picture of the incentives acting on fund managers accurate?

xiii. Why are performance fees not more common? What is the experience in other countries of performance-based fees?

xiv. What is the impact of risk management models? What is driving their increased usage?

xv. What has driven concentration in large parts of the fund management industry? Does this give rise to competition concerns?

Measurement of fund performance

19. It is suggested above that fund managers have an incentive to follow closely their prescribed benchmark. Measurement relative to other pension funds would then lead directly to industry-standard strategies. Measurement against an index or indices would similarly lead to a manager closely following the construction of this benchmark.

20. In practice, fund managers' targets are usually to outperform other managers with similar objectives by a small margin, which is even smaller after

covering the cost of management. The measurement periods used are normally a fraction of the period over which benefits are to be covered. Absolute return objectives appear to be used only by very mature schemes. Performance measurement over short time periods may help to explain the observation that institutional investors place a high emphasis on the liquidity and marketability of the investments they make, despite having mostly long-term liabilities and being strongly cash-positive.

21. There is evidence to suggest that many consultants and trustees are setting relative investment performance objectives with a high probability of disappointment over periods as short as three or five years. This may explain why as many as a third of all medium to large pension funds consider changing their manager arrangements each year.

Issues for discussion

xvi. Is the description of some of the incentive effects of benchmarks accurate?

xvii. Is the use of relative return objectives over fairly short time periods appropriate for long-term funds? What would the impact of longer time periods be on investment decisions and what could be an appropriate benchmark?

Transparency and public accountability

22. It is not clear the extent to which beneficiaries of a pension fund scheme are aware of fund performance, the objectives set for the fund or the benchmarks used and are therefore able to ask questions about them: in particular, to question the trustees and their advisers about the decisions they have made. The impression is that the Statement of Investment Principles is not a particularly effective vehicle for stimulating debate about the fund's investment strategy. There also appears to be little wider public discussion of the performance of occupational pension schemes.

Issues for discussion

xiii. Is there too little public discussion of, or dialogue with beneficiaries on pension fund performance?

xix. Might the quality of investment decision-making suffer as a result?

Accounting issues

23. Under proposed new accounting standards for retirement benefits (FRED 20), actuarial gains and losses on an occupational pension scheme would be recognised immediately in the statement of total recognised gains and losses rather than spread forward in the profit and loss account, and the full surplus or deficit in the scheme would be shown on the balance sheet subject to a recoverability test. There is debate over whether this will cause companies to change the way in which they manage their pension funds in future because of the possible impact on their balance sheet of pension fund performance.

Issues for discussion

xx. Will FRED 20 have a significant impact on the strategies of occupational pension funds, and if so, what will it be?

Regulatory and legal issues

24. The Pensions Act 1995 requires DB funds to meet the Minimum Funding Requirement (MFR). The principle of a funding requirement is an important and a necessary one, and any quantified requirement for a minimum funding level will tend to raise the propensity to invest in low-risk assets because this is the best way to ensure confidence about meeting crystallised pension liabilities. But it may be that the way in which the rules of such a requirement are defined has unintended and avoidable effects on decision-making. For example, other things being equal, as the fund approaches the MFR level, there is an incentive for it to match a liability with an asset whose return matches the discount rate used to discount the liability, since this ensures that the value of the liability and its corresponding asset are more likely to move in step. Since the current MFR formula uses rates of return on UK equities or gilts, it creates an incentive to invest in those assets.

25. It is important to remember that even if the MFR provisions did not exist, a well-administered pension fund will seek to estimate its liabilities for prudential reasons, and this process of asset-liability modelling will have incentive effects similar to the MFR. The main difference is that the MFR requires the use of particular discount rates. However, it is not clear to what extent asset-liability models use discount rates other than the MFR ones. Nor is it clear to what extent the choice of discount rates for liabilities is seen as a decision about asset allocation or merely a technical modelling exercise.

26. The Department of Social Security has asked the Faculty and Institute of Actuaries to review the MFR, and the Government will consult on their recommendations.

Issues for discussion

xxi. How important are the incentive effects of the MFR formula?

xxii. Do other aspects of the MFR affect decision-making?

xxiii. Do rules on valuation of assets have unintended effects?

xxiv. What is the impact of pension funds' asset-liability modelling on investment decisions?

Local authority schemes

27. Local authority pension funds are governed by different regulations from other occupational pensions. Although in many respects these mirror provisions of the Pensions Act and much of the above would therefore apply, there are also some differences. For example, local authority pension funds are not subject to the MFR, but are subject to prudential limits in certain types of investment instead.

Issues for discussion

xxiv To what extent do the issues above apply to local authority pensions? Have local authority pension schemes' investment strategies differed significantly from other pension schemes? Why (or why not)?

Individual involvement in investment strategy

28. There are some DC schemes where the beneficiary is allowed to influence the investment strategy used to provide their pension: for example, by picking one of a number of funds. Anecdotal evidence suggests that this can lead to "reckless conservatism" - for example, younger people choosing to invest their pensions money in near-cash instruments. This will require further investigation, looking at international (especially US) experience as well.

Issues for discussion

xvi. What is the impact of individual involvement in investment strategy?

xxvii. How wide a range of options do funds offer?

Life Insurance Companies

Corporate structure

29. Life insurance companies are under commercial incentives since they must compete for their business. In the case of a with-profits policy, there is an analogue to the “pensions promise”: a guaranteed amount which the fund has to deliver, but it only accounts for a portion of the likely final return, and one which has diminished over the last 20 years. It is also true that actuarial considerations play an important role, as they do with pension funds, so to some extent both types of investor tend to deliver the same output. But in principle, life insurance companies should have a more direct incentive to seek the best possible return at a given level of risk.

30. One would therefore expect them to exhibit more diverse investment strategies than pension funds. It is true that insurance companies invest in corporate bonds in quantity in a way in which pension funds do not: corporate bonds accounted for 13% of their portfolios in 1998. However, their levels of investment in venture capital, for example, are very low - less than 0.1% of their portfolios. It would appear that there may be issues here too.

Issues for discussion

xxviii. On what basis are the asset allocation decisions of life insurance companies made?

Measurement of performance

31. The use of benchmarks raises similar questions as raised above with regard to pensions. Measurement relative to competitors would tend to lead to industry-standard strategies, and measurement against an index would tend to lead to firms tracking the index fairly closely. The choice of target will also have incentive effects.

Issues for discussion

xxix. What incentives does current practice on the measurement of investment performance create for life insurance companies’ investment strategies?

xxx. Are there other competitive pressures on life insurance companies which create incentives for their investment strategies?

Role of Government

32. Life insurance companies are governed by funding requirements (the Solvency Margin) and associated actuarial guidance (the Resilience Test). It has been suggested that the formulae used to value assets for the purposes of these rules may affect insurance companies' choice of investment more than was intended for prudential reasons. In particular, assets which are classed as not being "readily realisable" may be particularly unattractive for insurance companies - for example, unlisted securities.

33. Tax is also a potential issue for insurance companies, since they do not have the same tax exemptions as pension funds. It may be that the details of taxation rules also have the unintended effect of making particular asset classes unattractive - for example, with regard to investment in limited partnerships, the normal vehicle for private equity investment.

34. Regulation of the sale of life insurance products may also have an impact, including inhibiting the development of investment products with higher risk and reward characteristics.

Issues for discussion

xxxi. To what extent might regulatory provisions make certain asset classes artificially unattractive, or inhibit the development of certain investment vehicles?

xxxii. To what extent might the detailed application of tax policy have a similar effect?

xxxiii. Might regulations intended for consumer protection have unintended effects on investment decision-making?

Other industry developments

35. In the past insurance companies have backed annuity liabilities with gilts, but increasingly they are developing innovative annuity products which lend themselves to backing by a proportion of equities. This may be opening up scope for more diverse investment by insurance companies. The regulations governing annuities may also be worth investigating.

xxxiv. What issues raised by annuities should the review investigate?

Personal pension/stakeholder schemes

36. Where individuals have no role in making investment decisions, personal pensions appear generally to be little different from life policies in practice, except that there may be less scope for pooling investments. Those schemes where individuals are involved in investment decision-making raise similar issues to those raised by DC schemes.

Issues for discussion

xxxv. What impact on investment patterns might the introduction of stakeholder pensions have? Are there other issues not identified previously which apply specifically to personal pension or stakeholder schemes?

Unit Trusts and OEICS

37. Some issues have already been identified. There are specific EU regulatory provisions which apply to unit trusts, limiting their investments in unquoted securities. There is also the issue of tracker funds. In practice, measuring an active fund against a particular benchmark has incentive effects which come close to replicating the effect of a tracker fund. But there may be particular issues raised by tracker funds - for example, that there appears to be a lack of mid- and small-cap trackers, with a consequent impact on investment flows. There may be other issues relating to unit trusts and OEICs.

Issues for discussion

xxxvi. What is the impact of regulation on unit trusts' and oeics' investment decisions?

xxxvii. What is the impact of tracker funds?

xxxviii. Are there other issues relating to unit trusts and oeics?

Conclusion

38. These are complex questions, and a document of this sort cannot cover all the possible issues. Responses are therefore invited on two final questions:

Issues for discussion

xl. Are there other issues relevant to these questions which the review should be considering?

xli. What measures could be taken to help tackle some of these issues?