aba – Arbeitsgemeinschaft für
betriebliche Altersversorgung e.V.

aba position paper
(17 July 2014)

regarding the

Proposal for a Directive amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement

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The aba - Arbeitsgemeinschaft für betriebliche Altersversorgung e.V. - is the German industry association representing all matters concerning occupational pensions in the private and public sector. The aba has 1,200 members including corporate sponsors of pension schemes, IORPs, actuaries and consulting firms, employer associations and unions, as well as insurance companies, banks and investment managers. According to our statutes, our mission is to represent existing schemes as well as to expand coverage of occupational pensions independent of vehicle.

aba positions

- Regarding the Proposal for a Directive to strengthen long-term shareholder engagement, **occupational pensions** are mainly affected by the requirements proposed in Chapter Ib "Transparency of institutional investors, asset managers and proxy advisors". In particular, the Proposal contains very **detailed requirements regarding engagement policy**. Institutional investors such as IORPs are i. a. asked to **publicly disclose** how the structure of their liabilities and their share investment strategy fit together. These requirements are applied both to **direct and indirect investments** if the company has **their seat in one of** the EU Member States.

- We support more transparency in proxy voting. However, we are against any steering effects as proposed by the Commission which would be expensive for occupational pensions, and even more so against any obligatory requirements. The implementation of the currently proposed requirements mainly **leads to more business for consultancies and companies representing shareholders** – to the detriment of occupational pensions. To avoid this, a **minimum shareholding threshold** should be defined – the legal obligation for an engagement policy should only apply above the threshold.

- The underlying perspective of the Commission on which Art. 3g and 3h of the Proposal are based seems to be that long-term investors (and their asset managers) should follow a buy-and-hold strategy without making major changes to their portfolios - and that they should get involved as active investors in the companies whose shares they hold. However, from our point of view these arguments are single sided and unrealistic. High portfolio turnover does not necessarily mean that asset managers face false short-term incentives. Therefore they do not necessarily lead to lower returns, but are **often part of a well differentiated investment strategy**. Turnover can also be increased by decisions regarding the risk management, which are partly down to prudential requirements.

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1. Overview of the proposed Directive regarding the encouragement of long-term shareholder engagement

On 09 April 2014 the European Commission published a Proposal for a Directive amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EC as regards certain elements of the corporate governance statement (Proposal for a Directive to strengthen long-term shareholder engagement).[1] The review is supposed to address the insufficient engagement of shareholders and lack of adequate transparency as seen by the Commission. **Occupational pensions** are mainly affected by the requirements proposed in Chapter Ib "Transparency of institutional investors, asset managers and proxy advisors" (see also pages 5 and 9 of the explanatory memorandum and recitals 9 to 12).

The proposed Directive contains requirements for institutional investors regarding a strategy for their **engagement policy**,[2] i. a. including (Art. 3f.1 of the Proposal):

"(a) to integrate shareholder engagement in their investment strategy;

(b) to monitor investee companies, including on their non-financial performance;

(c) to conduct dialogues with investee companies;

(d) to exercise voting rights;

(e) to use services provided by proxy advisors;

(f) to cooperate with other shareholders."

This engagement policy has to be documented and disclosed. If investors decide not to implement an engagement strategy, they will at least have to explain their behavior in a comprehensive manner (**'comply or explain',** Art. 3.4 proposed Directive).

In addition, institutional investors are supposed to **publicly disclose how the structure of their liabilities and their share investment strategy fit together** (Art. 3g of the Proposal). They are in particular supposed to disclose "how their equity investment strategy ("investment strategy") is aligned with the profile and duration of their liabilities and how it contributes to the medium to long-term performance of their assets." (Art. 3g.1 of the Proposal). We understand that these requirements refer to both direct and indirect investment in shares.

We are therefore disappointed that the Legal Affairs Committee (JURI) will be the committee responsible in the following legislative procedure in the European Parliament. Only the Committees for Economic and Monetary Affairs (ECON), for the Internal Market and Consumer Protection (IMCO) and for Civil Liberties, Justice and Home Affairs (LIBE) will be involved as committees for opinion. So far no involvement of the Committee for Employment and Social Affairs (EMPL), which is central for occupational pensions, is planned.

[1] Further information (press release, FAQs and impact assessment): http://ec.europa.eu/internal_market/company/modern/index_en.htm

[2] We agree that the term "engagement policy" is adequate. It should also be used in the German translation rather than the proposed "Einbeziehungspolitik". Because of their voting rights, shareholders are already "involved" (einbezogen) – what according to the Commission is missing is "engagement".

2. Definition of "institutional investor" – relevance for German occupational pensions

The definition in the proposed Directive includes Institutions for Occupational Retirement Provision (IORPs) in the definition of institutional investors:

- Art. 1 (2f) „Institutional investor" means an undertaking carrying out life assurance activities within the meaning of Article 2 and not excluded pursuant to article 5 of Directive 2002/83/EC concerning life assurance and any non-small institution for occupational retirement provision within the meaning of Articles 2 and 5 of Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision;

In Germany this definition includes:

- Pension reinsurances (Rückdeckungsversicherungen) which are often used for book reserves (Direktzusagen) and support funds (Unterstützungskassen)
- Direct insurance (Direktversicherungen)
- Pensionskassen and Pensionsfonds, which are subject to the IORP Directive; exemption for small IORPs (less than 100 members) is not relevant for Germany
- The subject matter and scope of the Directive is in principle defined in Art. 1.1 of the Directive 2007/36/EC as follows: "This Directive establishes requirements in relation to the exercise of certain shareholder rights attaching to voting shares in relation to general meetings of **companies which have their registered office in a Member State and whose shares are admitted to trading on a regulated market situated or operating within a Member State.**"
  - ⇨ This means the Directive is relevant for shares issued by companies which have their registered office in a Member State and whose shares are admitted to trading on a regulated market situated or operating within a Member State.

- Article 1b 4: "Chapter Ib shall apply to institutional investors and to asset managers to the extent that they invest, directly or through a collective investment undertaking, on behalf of institutional investors, in so far they invest in shares."
  - ⇨ Refers not only to **direct**, but also to **indirect investments.**

3. Imminent consequences in particular for IORPs

Most IORPs invest in shares through funds, fund mandates or similar constructions. These vehicles often follow market indices, which in turn are composed of many individual share values. As an example, the Stoxx Europe 600 contains – as the name suggests – 600 individual values. To comply with the requirements suggested in the proposed Directive, IORPs which use vehicles replicating an index would have to instruct the fund manager or the investment company (which is the legal owner of the shares) how to vote in the shareholders' meeting of the individual companies. From a practical perspective this is completely unrealistic! Service providers who could support IORPs in carrying out these duties exist (and who could also develop corresponding communication strategies making the shareholder engagement transparent), but ordering their services would mean additional costs for IORPs. These extra costs will have to be borne by the employer, or, depending on the situation, the employees and pensioners receiving the benefit.

In addition, a broad and diversified asset allocation – as opposed to capital participation – is intended to provide participation in capital market returns without entrepreneurial or operational involvement. Therefore it might not be the case that an IORP knows every company in a way which would allow adequate individual instructions. From our perspective this is adequate – deeper insights by IORPs is not necessary. Investments in shares – and opposed to investment in limited companies or other types of corporations - is constructed in a way to allow financial participation in companies without being an entrepreneur or developing strategies for the company.

⇨ The implementation of the currently proposed requirements mainly leads to **more business for consultancies and companies representing shareholders** – to the detriment of occupational pensions. The incentive effect contained in the proposal could also give rise to a tendency to invest in shares from outside the European Union, leading to less regional diversification.

⇨ To avoid this, the Directive should define an adequate **minimum shareholding threshold** only above which there is a legal requirement for an engagement policy. This minimum shareholding threshold should be set at such a level that IORPs which use index-based investment strategies are below the threshold (e.g. x% of the market capitalisation or share capital of the individual company in question and y% of the assets of the IORP). The effort and expense asked of institutional investors needs to be reasonably proportionate to the potential impact.

At least if a detailed explanation is given, the requirements for IORPs and assurance companies proposed in Art. 3f and 3g do not have to be met. However, this **"comply or explain"** provision (Art. 3f.4 and 3g last paragraph of the Proposal) introduces an element of obligation for institutional investors. It is in fact a reversal of the current situation, moving away from shareholder *rights* of institutional investors towards *obligations* for institutional investors. If the expectations of the Commission as envisaged by the Proposal is not met, there is a danger that in a next step a detailed explanation will not be enough anymore.

⇨ We support more transparency in proxy voting. However, we are against any steering effects as proposed by the Commission which would be expensive for occupational pensions, and even more so against any obligatory requirements.

4. The Commission's perspective on long-term investors is single sided

The underlying perspective of the Commission on which Art. 3g and 3h of the Proposal are based seems to be that long-term investors (and their asset managers) should follow a buy-and-hold strategy without making major changes to their portfolios - and that they should get involved as active investors in the companies whose shares they hold. They should not follow allegedly speculative investment strategies with high turnover in the portfolio. However, from our point of view these arguments are single sided and unrealistic:

- In the reality of investment policy a number of asset allocation strategies play an important role also for IOPRs with long-term liabilities (in particular when investing in shares via special funds ("Spezialfonds") with different fund managers). These asset allocation strategies are not or not completely based on fundamental data and can involve higher portfolio turnover, in particular because many IOPRs are primarily focused on (annually) achieving the guaranteed minimum returns by using an investment strategy which is responsible and risk aware.

- Furthermore, investors who focus on the long-term performance of companies can also have high portfolio turnover (e.g. if the envisaged share value is reached earlier than expected; the investor continues his long-term focus, but rates the share value of the company in question as too expensive and therefore withdraws his assets, potentially re-investing later at a lower price).
  - ⇨ High portfolio turnover does not necessarily mean that asset managers face false short-term incentives. Therefore portfolio turnover does not necessarily lead to lower returns, but are often part of a well differentiated investment strategy. Turnover can also be increased by decisions regarding the risk management, which are partly down to prudential requirements.
  - ⇨ Incentives to choose from a smaller investment universe (such as for example Art. 3g calling for an explanation of supposedly short-term investment strategies) often lead to higher risk and less diversification.
  - ⇨ The steering effect in Art. 3f and 3g of the Proposal goes against the prudent person principle. This principle, which is the basis of the investment rules for IORPs (see Art. 18 IORP Directive and, for the future, Art. 20 of the Proposal for an IORP II Directive). These rules include no specifications regarding specific investment strategies.
- At the same time, this perspective does not recognise important differences between different groups of institutional investors, and it is questionable whether the regulatory call for more engagement will lead to the desired results.

Serdar Çelik and Mats Isaksson, authors of an OECD research project regarding Corporate Governance, Value Creation and Growth, make the following points:

- The varying degree of shareholder engagement is down to the significant differences within the very heterogeneous group of institutional investors. When considering the different business models and influences of investors, it is at the same time rational and sensible: for some institutional investors active engagement is a vital component of their business model, for other investors active engagement has no function and represents only an extra cost. Encouraging engagement or making it obligatory is not necessary in case of the first group, and unlikely to lead to significant improvements in engagement for the second group, but rather to a tick-box-exercise and /or outsourcing to service providers who will seek to comply with the least effort possible. [3] (see also next point)
- The mere obligation to more engagement will not necessarily increase the quality of engagement by institutional investors. This is in particular the case if – because of cost and practicality – engagement policy is outsourced to service providers who give relatively standardised "advice" on how to vote. At the same time the market for this type of service is very concentrated, which is likely to lead to similar voting behaviour / herd behaviour rather than desired diversity of assessment and opinions of market participants.[4]

[3] Çelik, Serdar and Mats Isaksson, "Institutional investors and ownership engagement", *OECD Journal: Financial Market Trends*, Vol. 2013/2, p. 94 (http://dx.doi.org/10.1787/fmt-2013-5jz734pwtrkc)
[4] Isaksson, Mats and Serdar Çelik, "Equity markets, corporate governance and value creation", *OECD Journal: Financial Market Trends*, Vol. 2013/1, from p. 23. (http://www.oecd-ilibrary.org/finance-and-investment/equity-markets-corporate-governance-and-value-creation_fmt-2013-5k40m1ntmhzs)

⇨ It is therefore questionable whether the desired objective can be achieved with the current proposal: a strengthening of the independent and pluralistic assessment and control of company management and performance by market participants, which is crucial for a well-functioning stock market. There is a danger that the Proposal in the end only would lead to similar decisions of proxy voters while creating additional costs for investors at the same time.

⇨ In particular if – as is the case for most IORPs – investors have to achieve a minimum return using a secure, risk aware and diversified investment strategy (required by prudential regulation) and because of cost considerations and practicality a more "passive role" is preferred, an obligation to engage is unlikely to achieve the actual goal of the planned legislation.

5. aba proposals to limit the damage

IORPs should not be faced with additional administrative burdens, which they realistically cannot carry at all or only at unreasonable extra cost. The aba therefore calls for

- Addition to Art. 1b.4 of the Proposals:

  "Chapter Ib shall apply to institutional investors and to asset managers to the extent that they invest, directly or through a collective investment undertaking, on behalf of institutional investors, in so far they invest in shares and they are above a threshold of x% of the market capitalisation or share capital of the individual company in question and y% of the assets of the IORP."

  Justification: To continue the for the beneficiaries sensible investment in shares, the Directive for the encouragement of long-term engagement of shareholders should not lead to a strategy which avoids shares (less shares or more usage of packaged share products). Because of proportionality and practicability, we consider it of utmost importance to introduce a minimum shareholding threshold under which no engagement policy is required.

- Addition to Art. 3f.4 of the Proposal

  "Where institutional investors or asset managers decide not to develop an engagement policy or decide not to disclose the implementation and results thereof, they shall give a clear and reasoned explanation as to why this is the case. For passive mandates and other investments which merely replicate a broad market index no detailed explanation is necessary."

  Justification: To continue the for the beneficiaries sensible investment in shares, the Directive for the encouragement of long-term engagement of shareholders should not lead to a strategy which avoids shares (less shares or more usage of packaged share products). This is particularly the case because share investment is already facing potential additional costs because of the proposed financial transaction tax. When holding mandates which replicate a broad market index, institutional investors do not set any incentives for the asset manager, because the latter does not take any discretionary decisions. The only concern is the cost efficient replication of the index in question.

- Amendment of Art. 3g.1 of the Proposal

  "Member States shall ensure that institutional investors disclose to ~~the public how their equity investment strategy ("investment strategy") is aligned with the profile and duration of their liabilities and how it con-~~

~~tributes to the medium to long-term performance of their assets. The information referred to in the first sentence shall at least be available on the company's website as long as it is applicable.~~ the competent authority that their investment strategy fits the profile and the duration of their liabilities. This requirement can be met in the ALM studies.“

Justification: A submission of the investment strategy at the competent authority has to be sufficient. We are against a broad public disclosure, because potential speculation in the capital markets against IORPs and to their detriment is to be avoided.

- Deletion of Art. 3g.2d:

  ~~“how the structure of the consideration for the asset management services contributes to the alignment of the investment decisions of the asset manager with the profile and duration of the liabilities of the institutional investor”~~

  Justification: The call for disclosure of how the structure of the consideration for the asset management services contributes to the alignment of the investment of the asset manager with the profile and duration of the liabilities on its own does not make sense. Generally shares are only one part of the asset allocation (in addition to bonds, real estate, private equity etc.), which means that it does not make sense to look exclusively at the share strategy in relation to the overall liabilities. It only makes sense – as it is designed in Art. 18 of the IORP Directive and in the future in Art. 20 of IORP II – to use a portfolio approach, which looks at how the overall asset allocation is aligned with the overall profile and duration of the liabilities. An isolated assessment of the share strategy outside of the strategic asset allocation (spreading the capital to different types of investment) does not lead to meaningful results.
  In addition, the percentage of shares of the overall assets is regularly calculated as part of ALM studies, which also contain the share investment strategy. The results of these ALM studies include sensitive information about the institutions in question and should therefore not be publicly disclosed.

  Consequently, Art. 3g.2a and 2d of the Proposal do not make sense either – they also call for an alignment of the share investment strategy with the duration of the liabilities.

- Addition to Art. 3g.2.2 of the Proposal

  “Where the arrangement with the asset manager does not contain one or more of the elements referred to in points (a) to (f), the institutional investor shall give a clear and reasoned explanation as to why this is the case. For passive mandates and other investments which merely replicate a broad market index no detailed explanation is necessary.”

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