UK pension sustainability and fund manager governance: Agent duties to the principal

Abstract

Sustainable investing includes the application of non-financial (Environmental, Social and Governance (ESG)) criteria to asset selection in institutional investor portfolios (Capelle-Blancard and Mojon 2011). The article explores the implications for applying ESG screening *to* the institutional investors making the asset selections. Institutional investors are a heterogeneous group of investors, with fund managers specifically being some of the largest listed organisations globally (Ingley and van der Walt 2004). Whether their own corporate management duties to fiduciary governance (the G in ESG) benefiting their shareholders has any material impact on the financial returns outcomes of the pension asset management contract, and specifically whether there is a fiduciary conflict favouring of the exclusive best interest of fund management shareholders is the question addressed by the paper.

Key words: UK pensions, fund managers, sustainable investing, ESG, corporate governance, fiduciary duties, Principal-Agent theory

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Sustainable investing includes the application of non-financial (Environmental, Social and Governance (ESG)) criteria to asset selection in institutional investor portfolios (Capelle-Blancard and Mojon 2011). The article explores the implications for applying ESG screening *to* the institutional investors making the asset selections. Moving away from the moral ESG screening of ethical or impact investing, it examines these non-financial risks (and opportunities) for the potential of becoming financial risks, thereby seeking to protect asset owners against future valuation shocks (Freshfields 2005). In 2014 the UK recorded £5 trillion in assets under management in the financial services industry, with the accumulated pension assets accounting for 38% of the industry total (Meade 2014). This is a significant industry of social savings, systemically critical to the stock market and economy, and the security of the participating workforce (Monks 2002). In order to protect the investment of these contributions, pension trusts have been handed legislated and court appointed fiduciary duties (Richardson 2011). Adolf Berle and Gardener Means (1932) described the essence of these duties:

Taking this doctrine back into the womb of equity, whence it sprang, the foundation becomes plain. Wherever one man or a group of men entrusted another man or group with the management of property, the second group became fiduciaries. As such they were obliged to act conscionably, which meant in fidelity to the interests of the persons whose wealth they had undertaken to handle. (Berle and Means 1932, p.336 cited Boatright 1994, p.394).

This obligation demands pension trusts undertake to invest member contributions with attention, expertise and care (Pacces 2000). In order to fulfil the duty the majority outsource their assets to financial experts, the corporate intermediaries of the finance sector. These contractual relationships exhibit typical principal-agent characteristics, where the principal lacks the expertise to carry out a task and enlists an agent with relevant expertise to act on their behalf (Eisenhardt 1989). The law of agency confers strong commitments on the agent to protect the principal, and specifically to avoid using their advantageous position to the principal's detriment (Lan and Hercleous 2010).

Yet the fiduciary duty Berle and Means were describing was that of corporate management to external shareholders. Institutional investors are a heterogeneous group of investors, with fund managers specifically being some of the largest listed organisations globally (Ingley and van der Walt 2004). Whether their own corporate management duties to their shareholders has any material impact on the financial returns outcomes of the pension agency contract, and specifically whether there is a fiduciary conflict favouring of the exclusive best interest of fund management shareholders is the question addressed by the paper.

Conflicted fiduciary recipients of funds management

The literature informs us that corporate governance is important to the stable and appropriate performance of corporate entities (Hutchison 2011; Bebchuk and Weisbach 2010; Aglietta and Reberioux 2005). Gillan and Starks (1998) define corporate governance as the system of laws, rules, and factors that control corporate operations. Its purpose is to control the classical economic agency problem Jensen and Meckling (1976) described as the separation of those who provide the money from those who control it. Shleifer and Vishny (1997) describe it as the way in which suppliers of finance assure themselves a return on their investment. LaPorta et al. (2000) broaden participation to both shareholders and creditors, protected from expropriation by the law. The pension principal is equally a supplier of finance to the fund manager, whose corporate purpose is to maximise the return on investment on pension client assets. Triantis and Daniels (1995) remind us that in the banking industry shareholder supplies of finance are mostly outweighed by depositor contributions. As far back as 1976 Robert Charles Clark described depositor protection in the retail banking industry as establishing the trust and confidence required to attract depositor finance, given that deposit financing dwarfs equity financing on the balance sheet. Clark (1976, p.6) described a bank's shareholders as "elite suppliers of capital" typically less numerous, wealthier, and suppliers of a smaller and static proportion of the funds used by banks. These same observations could be made of the finance corporations that manage pension funds, yet they seem conspicuously absent from scrutiny (Bogle 2009). Figure 1 speculates on a principal-agent tipping point, where the principal of chief fiduciary duty to the fund manager converts along the organisational spectrum from the pension client to the external shareholder. This suggests the possibility that the corporate governance of fund managers may be detrimental to the pension trust where the fund manager is maximising shareholder wealth.

[Insert Figure 1 here]

The literature concentrates on empirical correlations between all aspects of corporate governance and financial performance (Kadyrzhanova and Rhodes-Kropf 2011; Khan 2006; for a meta-analysis see Orlitzky et al. 2003). It also analyses fund management financial performance, particularly the search for a relationship between sustainable investment and fund manager outperformance (for literature reviews, see Capelle-Blancard and Mojon 2011; Hoepner 2007). What the paper addresses is how the conflicted governance of publicly listed agents tasked with sustainable wealth production for both shareholders and pension clients may affect the pension principals' net performance after fees and charges.

Critiquing fund manager performance: Using finance theory, needing agency theory

In the behavioural analysis of capital channelling, Franklin Allen (2001, p.1165) asks "do financial institutions matter?" Financial intermediation theory assumes investors enter the market directly, incurring market-induced transaction costs for channelling pooled savings through the banking industry as borrowing and lending, or through the stock and commodities markets as investment in assets (Levine 2002). The finance industry is theoretically an agora for buyers and sellers to come together. Allen (2001, p.1166) argues "how can it be that when you give your money to a financial institution there is no agency problem, but when you give it to a firm there is?" The narrow focus of corporate governance theory remains on the real economy, and financial intermediation theory exists in the oddly assumed institution-free finance industry, so that these phenomena need not be analysed in unison (Bogle 2009). In reality investors are dependent on financial institutions for information and transactions execution, dependent on their fiduciary obligations of disclosure, honesty and promise keeping (Dunfee & Gunter 1999). These are the functional outcomes of the corporate governance mechanism for shareholders, not clients.

The appropriate unit of measurement for analysis of the effect the agent has over the pension principal is the *net* outcome of the investment performance achieved by the fund manager after all fees and charges. The agent should protect this principal and specifically avoid using their advantageous position to the detriment of their in-hand returns (Lan and Heracleous 2010). Economic agency theory hypothesises that the pension trust will incentivise the fund manager to the extent that it is in the efficient best interest of the agent to deliver this (Jensen and Meckling 1976). Pension trusts are compelled by law to act for contributing beneficiaries for the "exclusive purpose of providing benefits to them and defraying administrative expenses" (Greenwood 1996; see Cowan v. Scargill for the landmark case law on duties). To discharge the latter duty, pension funds must ensure that the fund managers' fee for handling their assets represents a fair price for members (Kay 2012).

Depending where the fund manager sits on the governance spectrum, they are presented with a conflict of interest that pits their fiduciary duties to shareholders against their agency duties to a client vulnerable to information asymmetry. The Law Commission Review (2013, p.21) interpreted the fiduciary standard owed by the fund manager as "ensuring that the direct and indirect costs of services provided are reasonable and disclosed, and that conflicts of interest are avoided wherever possible, or else disclosed or otherwise managed to the satisfaction of the client or beneficiary." Conversely, in its consultation with pension trustees, it found that "many trustees were aware of their status as fiduciaries, which resonates with a sense of altruism. Trustees contrasted their special status as fiduciaries with the focus of others in the investment chain on making money" (Law Commission Review 2013, p.7). This sentiment is endorsed by the Nicholls and Brown (2013) survey into investment management fees, concluding that disclosure may be an issue for pension trusts "particularly as the[se] fees are high in relation to the returns achieved". In contrast the Investment Management Association asserted fund managers' rights to pressure pension trusts into non-disclosure agreements regarding fees; a development David Blake of The Pensions Institute describes as "an outrage" (Sharman 2014).

Many pension mandates now require non-financial performance (ESG) screening of their portfolios for various ethical and financial outperformance motivations deemed beneficial to their membership base, and many fund managers differentiate themselves in the market with this capability (Kay 2012). The sustainable investment literature continues the search to link ESG excellence to financial outperformance (Hoepner and McMillan 2009). If there is a link between ESG excellence and the financial outperformance of a listed entity, it should consistently apply to a listed fund manager. Fund manager absolute risk-adjusted return on investment outperformance of an agreed benchmark is analysis of financial performance alone. Agency characteristics include justifiable fees for performance towards the pension principal. However the theory would hold that ESG excellence in the fund manager is governance excellence favouring returns to the shareholders as their asset owners. These returns come from the fees for handling client assets (Kay 2012). It should be incumbent on pension trusts to consider the non-financial performance of fund managers in the discharge of their fiduciary duties to the trust members, and an important consideration in the pension trust's fund management selection framework.

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