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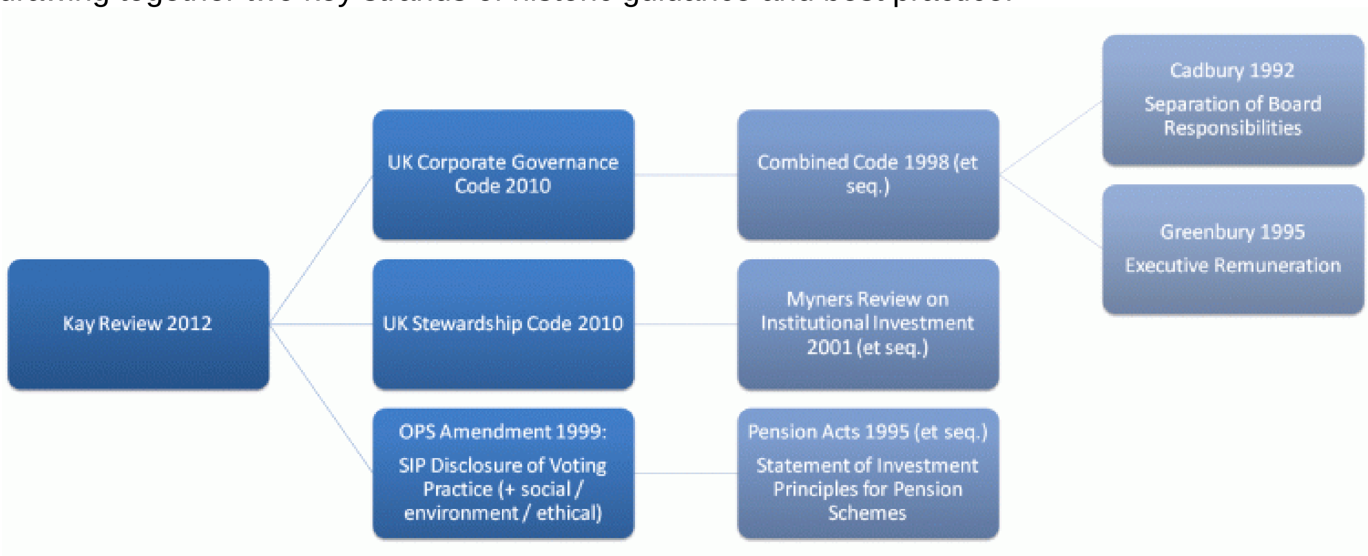
The Kay Review – Governance of UK quoted companies and institutional investor engagement

26th September 2012

On 23rd July 2012, Professor John Kay published the final report on his independent review examining the UK equity markets and the impact of investment on long-term corporate performance and governance.

Since then, the report has received relatively limited coverage despite its strategic importance in drawing together two key strands of historic guidance and best practice:



We believe that this is due largely to a perception of tension between the Review's recommendations and existing accounting practice and that the issues raised might be seen as too complex to fix due to the interactions of multiple agencies with differing priorities.

The Review correctly diagnoses an over-emphasis at the corporate level on short-term success at the expense of long-term building of the business. Kay correctly identifies the declining influence of the UK equity market; it seems gradually to be moving away from being a source supporting day-to-day commercial activity and instead forming a more intermittent resource for raising capital for M&A activity or balance sheet reorganisations.

Professor Kay also notes the declining role of UK institutional investment since the 1980s and the 1990s in favour of more fragmented individual holdings, often held through pooled vehicles managed by asset management firms. It is worth noting that the high levels of institutional shareholding during those two decades were in themselves rather unusual – the Report's own data shows much lower institutional equity weightings in the 1960s. One should also be cautious of any implicit assumption that the historical consequence of higher institutional investment was enhanced corporate governance.

However, the Report is correct in challenging extended ownership/trust chains as any sort of effective route to providing governance promoting long-term aims. For instance, in the pension space, we commonly see:

- The long-term needs of a member are provided by,
- A pension scheme, which is required to account for assets using mark-to-market methodology and also (for DB) to require funding on this basis, investing via,
- An asset manager which is likely either tightly benchmarked or has performance regularly measured on a market capitalisation basis, which invests in,
- Shares in a corporate, whose Board adopt short-term performance metrics for success and remuneration, and whose other shareholders also adopt a short-term view ...

... and this situation may well get worse for DB schemes if the Solvency II / IORP II initiative is implemented in something like the form laid out in current proposals.

It is possible for pension schemes can make progress here, by focusing on the Review's eight components of Good Practice for Asset Holders, and those who have previously focused on their governance / ESG policy may be ahead of the curve, for instance:

- Schemes need not slavishly benchmark against market capitalisation weighted indices
- Longer term performance measures can also serve, provided processes are in place to measure the competence of managers and overall scheme health on a regular basis
- Asset managers should seek opportunities to engage with their clients and schemes can use this to press for reports on voting records and, ideally, to promote proactive company engagement
- Scheme investment staff should identify current issues and use these with asset managers to push governance up the agenda
- Third party entities also promote governance, ethical investment and to provide information to beneficiaries and schemes in this area. Whilst most schemes will not be in a position directly to act on this information, it can be used as an opportunity to engage with asset managers

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Veasey Associates is a business trading name used by Martin Veasey.

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