

## Questions

Q: (Adam Ramsey from People and Planet) Specifically to Lord Myners you talked about how many of the same institutions owned many of our banks and of course the best example of that at the moment would be UK Financial Investments who own a large number of banks and of course are the majority shareholder in RBS. You talked about the need for these institutions to interfere with banks but when you were city minister you refused to change RBS's ownership which led to investments in things like Tar Sands and many of the issues that the organizations here today campaign on. My question is what was it that was preventing you when you were minister from introducing those kinds of interventions?

A: (Lord Myners) Well we only owned some of the shares, we didn't own all of the shares and I think if we wanted to use these banks as an instrument for social and political purpose than we had to own 100% of the shares then we would be able to answer to the UK tax payer alone. But I think as long as there were minority shareholders we should treat them as though they are conventional companies. Our real wish was to see these banks return to private ownership as quickly as possible I believe it would be wrong for these large banks to be owned by the government or for the feeling to be that they were somehow directed by ministers and that is one of the reason why we created UK Financial Investments to keep them one removed.

Q. (From F and C) A question for both of the speakers. I think there is probably quite a lot of empathy in this room for the view that trustees really are the key for changing a lot at the moment but the challenge is how exactly do you do that? So my question is how do you plan to do that?

A: (Anne Simpson) I'm happy to start, I with great respect disagree with you, and I think trustees are sitting in a really impossible situation. The way that trustees arrive through the channels that they do arrive at the moment means they may or may not have the training that that they need, they may or may not have the advice, the time to do their job but my view is that there are structural problems in the situation which make their job almost impossible. And that is why I would return to the fact that pension funds do not have the money in there to deal with the risk that they've been taking, they've been chasing risk in order to get the returns they need, to try and tackle their deficit and I think that they are pretty exposed and unless we do something which means people die younger or contribute more or work longer or we put more money in I don't think the investment proposition is an easy one. And if you look at the most wide range of performance for pension funds it's very hard to match it up against different categories and types of trustee failure to meet the market is a ubiquitous failure. Paul can obviously talk with more knowledge on the fund management side about this but it's pretty shocking to me to realise that the majority of funds pay active management fees and they underperform in the market. I mean that was true 20 years ago when I first started in this world and it is still true now so the poor trustees I think have a very tough job and I wonder if we haven't given them an impossible job and if it is the job that needs reworking.

(Lord Myners) I think we are where we are and we've got to try to make this model work better. I'm a sad person, I occasionally accept invitations to go and speak to pension fund trustees and I go and I say that I don't have any product to sell, I don't have any service to sell, I'm probably the only person who will ever sit in front of you who doesn't have a commercial interest in the outcome of this meeting and I end up by telling them that I think that they should cancel their next meeting with their fund managers, most of them meet with their fund managers every 90 days which of course is so bad when your funding liabilities that won't be paid for 40-50 years. What a very good way of converting long term capital into short term capital, what a crazy way to run a marathon on the basis that your performance is assessed every 100 yards and if you have 3 sequential 100 yards where you come in the second half of the race your out of the race. That's how we do it, and what I say to the trustees is cancel your next meeting with the managers, tell them not to come, but hold the meeting and get a whiteboard, several whiteboards and try to think, what are we trying to do here, what is our task, how are we squaring with the rate of return, what do we understand by risk, how much risk should we be taking, what skills and competencies do we require to do this job properly and do we have those skills and competencies and, if we don't, how should we acquire them? What can we manage, what can't we manage? I think that framework of debate in itself which I think very few trustees have been through would be extraordinarily helpful and I encourage trustees to do that but for some of them its just a bit too frightening, it's a bit too much stepping into open space without the protection of having the fund managers in every 90days. I believe it can be changed I would like to see more professionalism of trustees I would like to trustees more businesslike in their affairs less led by the consulting actuary more in charge of their own agenda, then they can begin to ask question that lie at the heart of what I think is a fundamentally flawed model which has led to agents prospering but principles suffering to some extent at the expense of the agents.

Q: (Researcher) I'm very interested the universal ownership concept, I looked into figures over the last 5 or 6 years of banks and financial services and it seems almost illogical in contrast with the amount of attention given to the manufacturing sector, certainly in Europe and the United States. One thing that occurs to me is that if you want real outputs not nominal outputs in investment strategy the government should talk seriously to trustees about a distributive element in corporation tax so that senior fiduciaries in our society, institutional fiduciaries and the public fiduciaries can come to some sort of agreement about what is preferred, so green investment for example is the preferred option we should have some method for distributing tax to prevent the problem which currently is that all the returns, all the profits goes back to the financial sector which allows it to grow at the expense of the manufacturing sector, any comments?

A: (Lord Myners) One of the dreadful thing about being a minister is answering parliamentary questions when you have to take questions from around the house on a broad subject, and one of the things that you learn to do is latch onto one word, and once you find a word that you recognise you speak to that word for a minute and a half, I'm going to speak to bank profitability, which was somewhere in your question. I think that one of the core issues of profitability is that banks have been undercapitalised, banks

survive because the state stand behind them and this also allows high reward in many cases to people that don't have exceptional talent. I am not at all opposed to paying rewards to talented people; I simply question whether all the awards are going to people with talent and whether boards of directors and management have done enough to institutionalize knowledge in order to reduce dependence on key people and key teams and whether they have more to develop bench strength in the organization so that they can't be held to ransom by teams. This is the sort of question that shareholders should be asking banks and they should be asking banks privately but also at annual general meetings. They have the voice to do it; they choose not to do so. Perhaps they are too intimate themselves in the same community but I think one of the problems and why money and talent has flowed to banking and finance is because the industry has historically been undercapitalized and a result of which it has been able to rewards investors and employees very well. A better capitalization will lead to a more balanced, a higher capitalization of the banks will lead to relatively better returns for manufacturing and other industries which should move the balance of the economy in that direction over the long term.

(Anne Simpson) Ok, I can speak to a slightly different part of your question, about profit at banks being at the expense of manufacturing. Now there is quite a complicated story here about what banks do to make money. In the old days, if you've seen Frank Capra's lovely movie, *It's a wonderful life*, and, its like, 'I want to build my new machine and I go to the bank, and he's known me since I was this high'. You know, there is a whole notion about banking and I think in continental Europe the structure of banking and bank lending is quite different. Now, what's happened is that banking has turned into quite a different industry and this is a debate, you know the capitalization debate, the function of banking debates that are going on and the notion that investment banking, which is really where the money is being made is a very different business to that of banks providing credit to business and whether it is manufacturing or other sectors there are some real discussions about that to be had. On the CalPERS portfolio this question about making capital available for new businesses I think is a really serious issue and I can tell you that one of the problems right now for us is opportunities and that you get into a situation where you've got more money chasing investment opportunities than opportunities exist. One of the difficulties is that we have had a gutting of manufacturing in certain markets under competitive measures by globalization due to cost and those jobs in manufacturing are not going to come back to Detroit, they are not going to come back to Sheffield and we are living in a world where we have gone through a painful transition. So I think there are some bigger, mega macro economic issues about where does our competitive advantage lie? I don't think the tax system between the financial sector and manufacturing will solve that there are all sorts of complex and interesting issues, but globalization and off-shore manufacturing costs and parts is a big part of it, bank lending I think is just one aspect.

Q: (Peter Montana, Financial Reporter) I am a long-standing admirer of CalPERS and became a more ardent admirer last year when you joined Anne. I agree with a great deal of what you said and also I agreed with a great deal of what Paul said. Although, I would qualify the remarks about diversified portfolios by noting that they have a huge

advantage in making easy recapitalization of companies in difficulty which is not the case with concentrated portfolios and that was a huge strength for this country last year when the market re-financed a lot of companies with a lot of money. I just wanted to ask is where I begin to worry a bit is this very easy solution that it is all up to the owners and trustees, and I agree that it should be. I think that one need look a little bit at what the incentives these people are facing now, the incentives are actually tilted against long-termism in so many different ways. First of all if you look at the solvency requirements on insurance companies it tells them don't invest in equities, I mean so the idea of getting insurance companies to fix this corporate problem won't work if regulations are telling them only to end up in bonds, if you look at the accounting requirements for pension funds and you look at the discussions in Europe, in Brussels on solvency for pension funds it could well be riding in the same direction. If you look at the relative taxation of debt and equity it encourages companies to fund through debt. If you look at the general thrust of the debate on market regulation it has been a never-ending quest for more liquidity which has led to great deal of short-termism and you yourself mentioned the pressures to produce returns and of course all those training opportunities create this, create means of resolving the pressures if you look at diverted technology, lending stock, high-frequency trading, it almost becomes impossible to know who owns anything. Before long we could be in a situation where there is a vacuum. My question really is can we address these problems simply by resolving to be good from now on? Or do we have to really get to grips with this long-termism question? My question is what is the state playing miracles question, are we getting somewhere or are we still stuck in short-termism? What is a practical way of setting about it because if we can't it's a bit tough on the pension fund trustees who may in the end actually not have any power because they don't own any shares.

A: (Anne Simpson) Well just to take the first part and I have to pay great respect as a visitor from the mother country, America. I think it is an extremely difficult problem and congratulations to Vince Cable for opening this up and I would also say that Ira Bernstein at Yale is just opening a project up there that looks at short-termism. So I think we need the issues that you talked about in accounting, tax, all of this, I would just like to add one more which is on my mind at the moment which is the invention of share options, the invention and obsession with incentive pay. I find it, and again disclosure is caveat, I now speak as Simpson of Finsbury Park not Sacramento, CalPERS person, I find it extraordinary that we have thought simply to do one job, one need to be compensated. This is the word in America, remunerated it is over here. The decent idea that you have a salary, that you have a pension, if you're lucky, that is now seen as a luxury, extraordinary isn't it? I would say that we invented a rod for our own backs that the shareholder community has lived to rue the day of what incentive compensation does. Now what's happening in the United States is quite interesting because, they've, courtesy of Meza's Dodd Frank we will have a 'say on pay' vote from the spring and I expect it do sweet Fanny Adams. This is because you can't hire and fire the board, which you can't routinely do in the United States, it just seems to be a feather duster that doesn't do anything. What we are doing is almost legitimising the notion that management should be focused on the share price in the short term and it will hit their wallet in a very nice way if it all goes well. Now, imagine how different it would be if your working for a company

and your share price goes up, your share price goes down and you don't have options, you don't see your personal wealth rising and falling with the stock market or with earnings announcements or with analysts calls or decisions about mergers and acquisitions on the short-term or financial engineering that loads up the balance sheets with debt, there are so many ways in which what we have done is pervert incentives by inventing incentive compensation. And I do think the old fashioned stuff about agency theory, alignment and all that jazz is really very powerful. So you now see, in the United States, CEO tenure, you know you couldn't grow a decent vegetable patch in the time that it take to turn over a CEO in the United States and what that means is in the United States we are almost at the very beginning saying that there should be performance targets for the awards of options. This is not decent behaviour to rewrite the targets if you miss them and then, how about the idea that you have to perform over a 1-3 year period? This is seen Peter, this 1-3 years, as long-term. This is simply not good enough so, I would like to see some bold thinking in the realm of executive pay and I think if we could actually crack that we would do something to tackle something that is quite toxic. I don't think we are anywhere near this and actually 'say on pay' and the other feather dusters around this idea like disclosure, advisory votes hasn't really got to the root of the problem because I think it is very corrosive.

(Lord Myners) I agree there needs to be a debate about the long term; I think some of my own thinking is designed to focus our attention on the longer term. On the issue of diversification I think I talk about obsessive diversification, Bill Sharpe says an equity portfolio will have most of the diversification we require with 25 holdings rather than the 200 or so holdings that you might often find in a portfolio. Vince Cable was mentioned, I don't believe that self-flagellation is sufficient to make one a saint, I think Vince has to do something, Vince has to do more than simply look uncomfortable. I've done some of these government reviews, if you want a review to work you choose a high profile person to run the review whose got energy and will put his and the group's energy behind the review. If you don't want the review to work you ask a mid-level civil servant to carry the review, you don't allow that civil servant to give any interviews and you don't allow that civil servant to take any public evidence. Check the methodology used to carry out Vince's review into long-termism and I think you'll see something that is just designed to kick the issue into the long grass, placate Vince while the treasury are pursuing a rather different agenda. I think your right Peter on the solvency issues, although I think we need to address whether we have been too conservative on solvency for insurance and pension funds. Some of the core assumptions around solvency that CalPERS, full of virtue as they be, probably do 90-day valuations and they value individual holdings on the last traded price, on the last day, on the last minute of the quarter to produce a portfolio. How do you do your portfolios? I imagine that's what you do, and I want to suggest that's completely nonsensical, it's the way every else does it, except maybe CalPERS. It's nonsense to assume that your whole line of shares can be sold at that price in the last minute of the quarter. So lets stand back, lets be more realistic, the market price, is the market's very small line of stock and not huge holdings so lets not be too hung up on issues of market price and solvency. The fact is, almost everything we do suits investment bankers, stock lending suits investment bankers, hedge funds suit investment bankers, high frequency trading suits investment bankers, our predilection to take over certain bits suits

investment bankers. The principles are silent in this debate, no voice at all for the investors and I think this is a great shame. But the ABI, the governance functionary was there, the APF and other organizations do take these governance issues very seriously and they are very committed to it but they are commercial organizations, they are trade organizations, they have other agendas and I think it's a great shame that there isn't an organization at the moment that speaks on behalf of institutional investors. Finally on incentive compensation, Ann is right; we have inserted the fund managers' targets into the executives' targets, TRS, rolling 3 years, etc. We have hugely complex remuneration schemes, institutions should reject them, if you can't explain your remuneration scheme in a page and a half the institution should reject them. If it takes 12 pages it's too complicated to have any utility at all. Unfortunately we are lazy people who like to hide behind formula and so we are happy with this approach. I would like to see executive compensation and reward become far more subjective. I think the non-executive directors are there to make decisions about remuneration, if the shareholders don't like it they should move the non-executives. Forget all this nonsense about TSR and the other formula that you see in annual reports now.

Q: (James from the Nuffield Foundation) Regarding long-termism, I think pension trustees, more than anybody are short-term investors because they are measured so frequently, every three years they are evaluated. The consequence of these evaluations is having to put a lot more money into these schemes. So my question to Anne is, if you were an unrestrained investor what would the CalPERS portfolio look like?

A: (Anne) Well it's good timing for the question because the board is right in the middle of a triennial, a regulatory required interval, a triennial asset allocation review. So let me just tell you what's on their mind, though the decisions won't be made till next month. Over this whole year we have had a series of workshops with the board bringing in interesting people with new ideas come and talk about what they think the new normal is in the global market. For example, allocating assets according to market capitalization is simply driving using the rear view mirror; there is nothing about future growth. If you were to have an investment strategy which was saying 'how can we get exposure to genuine economic growth?' you would not have money tucked into Japan, you would be more interested in Vietnam, you'd be more interested in high-growth economies, you be looking at demographics. So what our board is looking at is moving towards a factor-based approach to strategy, in other words you don't say 'Lets look like everyone else, lets have a bucket of money in public equities, a bucket of money in fixed income'. Instead we need exposure to economic growth, real as opposed to valuated or engineered growth. What would that mean? *Global Equity* did a workshop with the board last week and they said if you were to take the IMF's growth predictions globally and map CalPERS to that it wouldn't look anything like it does at the moment, we certainly wouldn't have 40% in the United States which is growing to grow at 2%. It's back to what we said about risk balance about risk returns, you want exposure to growth and then you want to understand what risk is. Paul was saying volatility is the only form of risk that anyone has been thinking about in the last 20 years. How about the risk of low-growth? How about interest-rate risk? How about inflation risk? I mean the tail-end of events and disasters is another form of governance risk. So our board is in the middle of

thinking about all of this and what level of risk are you willing to tolerate in order to be shackled to an 8% rate of return which is what most public funds have committed themselves to. So we have to do a deal with the employers about how money they are willing to pick up. So you say okay, CalPERS are going to go for 10%, but the investment strategy and the risk attached to that means that the employers have got to be willing to hold onto their hats and say we are going to kick in money. The reason that it gets short-term, I mean think about CalPERS, we pay out \$18 billion in benefits every year. When the credit crunch hit us we got into liquidity difficulties and had to sell things. With pension funds, unfortunately, you don't have one group of workers who work for 40 years, retire and then live for another 30 years. With 1.6 million people you have people joining, leaving, dying, becoming ill, retiring, getting made redundant and the cash flows attached to that are actually very complex. So you can't just sit there and say 'let's be long term, its all about capital growth'. We have a huge appetite for cash and for liquidity. The focus on liquidity is actually risk mitigation and so there is a debate going on at the moment about how you are so frightened about the beast that just bit you, are you willing to go out there and take the risks you need to get the returns? In this low-growth, high unemployment environment in California why would these small counties be willing to pony-up billions of extra money if you get it wrong? So, I think the long-term, short-term issue needs to be played out in that context. The very long term for CalPERS is when dependant of the youngest member of the scheme is expected to die. This makes us almost permanent which is why the valuation issue for us is more about cash flows than market values. When those liquidity decisions have been wrong for whatever reason, then you have to sell illiquid things in order to raise your cash and our smoothing exercise with our employers has been a 15 year exercise, just to answer your question Paul.

(Lord Myners) Yes, but the portfolio is never valued by reference to market prices.

(Anne) No, you're quite wrong

Q: Regarding your point earlier Catherine about some grass roots analysis of the banking sector, there is a Banking Commission, and I recommend every one to read *The New Economic Foundation* and *Positive Money*, the points that Friends of the Earth are bringing up. The University of Southampton's contribution to the debate has also been very interesting. My real question is there is a new organisation in embryo, which is trying to organize member nominated trustees in the UK. Unfortunately it's being led by a BECTU officer who's also a trustee on the BECTU staff fund; we would much prefer someone in isolation for obvious reasons. If you were going to start such an organization Paul, where would you place it? You've got this situation at the moment where BECTU is under the stewardship of solicitors and its sources of funding are questionable. So if you were to set up this type of organization how would you do it?

A: (Lord Myners) I think that you have gone a little bit out of my expertise, I think member nominated trustees have a valuable role to play. I think organizations like the TUC have done a lot to help member nominated trustees become familiar with the issues but I think they have helped them work in the existing model rather than to challenge it.

What I would like to see is some member nominated trustees to be 'experts' that may not necessarily work for the employer organization but that members would go outside and say, 'the person that we would like to represent us at this trustee body, to keep an eye on our interest is this lady or this man'. But I think there is detail to your question that I am not well enough informed on to answer.