PGGM Guidelines for the Compensation of Financial Service Providers

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PGGM

1. Introduction

The recent global financial crisis has fuelled the discussion about the functioning of the financial system in general and the functioning of the traditional asset management model in particular. Financiers of capital lack confidence in this traditional model. Conflicting interests related to costs and returns may arise between financiers of capital and financial service providers, such as external managers. This against a background of dwindling societal acceptance of high remuneration in the financial sector. On behalf of its clients, PGGM Vermogensbeheer B.V. (hereafter PGGM) selects financial service providers for some of its investments and it has a vision for the compensation of these financial service providers. These guidelines relate to both fees as well as to the remuneration of management and employees of financial service providers as individuals, collectively referred to as 'compensation' (see text box). In this, PGGM is focusing in particular on external managers through whom investments are made in funds or segregated mandates.

For the benefit of its clients, PGGM has developed a vision for compensation from the perspective of alignment and in relation to excessive compensation. What is deemed 'excessive' varies depending on the individual, the market and the investment category. There is growing pressure from our clients and pension fund beneficiaries, on whose behalf PGGM invests, to no longer turn a blind eye to the compensation of financial service providers. Although PGGM is faced with a challenge when it comes to defining excessive compensation, we will endeavour to take a stand against the most extreme forms of compensation using a phased and top-down approach. PGGM will begin a discussion with financial service providers and will, where necessary, take appropriate measures, and make every effort to ensure that investments for our clients are done in a responsible fashion. Alignment is an important factor in this. Should our efforts fail in due course to produce the desired results, then PGGM's proposal may be to no longer contract the financial service provider in question as an *ultimum remedium*.

From an alignment and cost perspective, we want sound and controlled fee structures and levels. Another perspective relates to the remuneration of partners, management and employees of external managers and/or funds. Remuneration generally comprises both a fixed and a variable component. We have no direct influence on the remuneration that external managers apply, except in the agreements that PGGM can reach in this regard in the mandates and the fees which we pay on behalf of our clients. In our opinion, remuneration must also be controlled and adequate in terms of level, risk and alignment. We will continue to draw attention to these aspects and take them into consideration when selecting financial service providers.

An important component in the broader compensation for external managers is that it is possible for partners, management or employees of external asset managers to realise their financial assets through individual investment profits. By doing so, assets can be realised in the same way as absolute returns are realised by institutional investors through (high-risk) investments. These individual investment profits can lead to extremely high returns for individuals. PGGM's vision does not aim to restrict such 'entitlements' as long as they do not conflict with the interests (alignment) and goals of our clients. Where individual investment profits are in fact insignificant (not necessarily in terms of the percentage

Definitions

In this document, we define the concepts below as follows:

Compensation – Monetary awards, non-monetary awards and/or other instances of financial value in exchange for work and/or services provided. In these guidelines for compensation, this term refers to remuneration or fees.

Remuneration – The compensation that individuals receive in exchange for work provided. Remuneration generally incorporates a fixed salary, a variable reward in shares and/or money, non-monetary awards, such as receiving training.

Fees – The compensation that financial service providers receive in exchange for the services they provide. Fees are generally used for salaries, other costs and profit.

Individual investment profit – Financial value creation from investments made by institutions or partners, management or employees/portfolio managers of those institutions or funds we invest in. This financial value creation is subject to investment risks similar to the way asset owners realise long-term financial absolute returns.

Financial service providers – Independent financial sector companies that provide PGGM with outsourced services, such as asset managers, fund managers and custodians.

of the fund or segregated mandate only, but also in terms of structure and individual circumstances), individual investment profits are in fact a form of disguised remuneration. In these cases, PGGM also treats this as remuneration.

Alignment problems between financiers and external managers manifest principally in three ways:
1. High compensation is paid out despite mediocre or poor performance.
2. High agent fees which are passed on in certain sectors of financial service providers, in particular in the field of 'rent extraction' (whereby the component of the fee surplus that a manager receives is too large).
3. There is insufficient focus on the long term in the remuneration structures in certain sectors of financial service provision.

In the coming years, PGGM intends to focus on these issues and believes that progress in these areas will result in a relative reduction in compensation.

An important distinction must be made between investments in which PGGM intends to realise a benchmark result (beta) at the lowest possible cost and for investments with which PGGM wants to realise better investment results (outperformance) than the benchmark (alpha). In addition to this, the distinction between investments in closed-end funds with a finite duration or segregated mandates (with indefinite duration) is pertinent. Another important factor is whether direct investments are being made, for example, in private real estate, infrastructure and private equity.

PGGM believes that the focus must be on increasing the alignment between the financier of capital and the financial service provider. For instance, management teams involved in direct and co-investments often have a significant component of their assets invested with the financiers of capital. Although these guidelines focus on external managers in particular, the principles also apply to the management teams and partners in direct and co-investments. For beta investments, PGGM wants to mainly pay management fees; for alpha investments, performance fees can be instrumental in creating an alignment. PGGM would prefer to only pay performance fees if a risk-adjusted return above a certain minimum ('hurdle') is achieved. A long-term horizon is essential in this. PGGM does not want to pay performance fees on behalf of its clients in situations where the hurdle has not been achieved. Clawbacks or long-term rolling performance averages are important instruments and yardsticks to prevent this and to keep it manageable.

We have identified additional concerns and problem-solving approaches for certain sectors within our investments. Within private equity investments, for instance, we have problems with structures like the so-called 'catch up' and 'American waterfall'.

2. PGGM vision

At PGGM, the work we do on behalf of our clients is our guiding principle. PGGM is conscious of the legislation and regulations in relation to compensation and the high societal pressure that our clients feel in terms of costs and compensation. Consequently, PGGM wants to offer products which are easy to explain to our clients as well as to their pension beneficiaries.

PGGM aims to reduce fees and remuneration, particularly in the sectors where agent fees are high. Even though we have seen progress in this context in some sectors, for instance, in private real estate, creaming off (surplus) income (rent extraction) using fees and/or remuneration is still high in other sectors, like private equity.

PGGM wants to take a clear position regarding fees and remuneration, but it is realistic about the fact that this requires a phased approach and that we cannot get too far ahead of the market. In this phased approach, PGGM wants to take market standards into account in the considerations about what we find acceptable at a certain point in time. We shall have to find a balance in terms of fees and remuneration between actively 'pushing' and possibly no longer investing with the best managers.

Ultimately alignment between the financier of capital and the financial service provider is the most important aspect of sustainable compensation. PGGM believes that proper alignment not only reduces costs, it can also improve results.

In summary, PGGM's philosophy is therefore as follows:
- PGGM believes in reward for real performance.
- Remuneration incentives which focus on the long term are effective.
- Compensation structures must be clear and transparent.
- Compensation structures must be aligned with the financier of capital's objectives:
  - No high compensation for poor or mediocre performance.
  - Restrict, over time, inappropriate structures and practices, like 'catch-up', 'American waterfall' and 'rent extraction' .

The most important instrument that PGGM has developed to give substance to this philosophy is the Fee Protocol. It contains agreements about acceptable rates and compensation structures for each investment category in which PGGM uses financial service providers.

PGGM is of the opinion that in the long term acceptable compensation must meet the following criteria:

- Basic fee: the management fee is only intended for covering costs and remuneration. Some sectors use a costs+ model.
- Performance fee: only for exceptional performance (exceeding a predetermined and challenging hurdle).
- Relatively significant financial assets can be realised if the fund manager makes individual investment profit.
- Transparency in the field of compensation structures, budgets and remuneration on the part of our financial service providers.
- Compensation must be aligned with sustainable absolute returns in the long term for our clients.

3. Current market vis-à-vis the PGGM vision

There are several areas where the prevailing market still deviates from PGGM's vision for the future:

Individual investment profit for external managers

One of the customary methods for creating alignment is through individual investment profit. PGGM is looking closely at the amount of invested (high-risk) equity capital that individual portfolio managers have themselves introduced ('skin in the game') on the basis of personal wealth, past profits, and so on. There are, however, still cases in which an investment team can achieve significant compensation with relatively low investment of equity. These cases would involve a young team that has not yet accrued equity capital. This is something which must be evaluated at individual fund level and which PGGM will continue to keep a close eye on.

The same applies to management teams in direct investments – here, too, there is not always enough 'skin in the game'. In this respect, too, PGGM is looking to improve the alignment with these managers.

Management fees that are considerably higher than costs: remuneration which is not in line with market conditions

We regularly see that external managers enjoy remuneration which is not in line with market conditions or that the budget surplus of the external managers is relatively high.

Both of these boil down to the same thing: the surplus is divided among the partners because of the partnership structure, for instance. In both cases the management fee realised is actually too high. PGGM believes that this is inappropriate and is investigating it in the investment process, for instance, by comparing the manager's remuneration structure with the rest of the market. This is not always obvious, however, because of the lack of transparency.

Other kinds of misalignment

The larger external managers, in particular, who offer a range of different investment products, often have complex remuneration structures whereby individuals are not only rewarded for the success of the funds which they themselves are directly involved in, but also for the success of the other funds that the organisation manages. This creates misalignment and PGGM considers this to be inappropriate. PGGM requires of its external managers that the remuneration of individual portfolio managers is principally related to the performance of the fund for which they are responsible and in which we invest.

Limited transparency

External managers are not prepared to divulge budgets and share detailed information about remuneration. Increasingly, PGGM will require its external managers to offer detailed transparency and in the long term it intends to no longer accept this kind of opaqueness. This is another area in which existing market practices need to change.

4. Implementation

PGGM is of the opinion that considerable improvement in the market must take place to realise its vision for compensation in the future. We believe that this change can be accomplished through more collaboration with like-minded financiers of capital and by developing alternatives, for instance, through direct investment, which will ultimately improve our negotiating position over time.

PGGM accepts that it will take time to change established market practices. Our approach will be phased and we intend to gradually tighten up our requirements. We would like to accomplish this by setting a clear goal for 2020. From that year onwards, PGGM will no longer accept the practices mentioned in Section 3 for new investments. For existing investments, PGGM wants to move in the direction of the desired practices as far as possible, while at the same time taking existing contracts into account.

PGGM aims to achieve this based on the following actions:

Tightening up PGGM Fee Protocol

PGGM has had a fee protocol since 2013. This is an internal document in which PGGM has stipulated how we handle fees for financial service providers. The Fee Protocol lays down the maximum fees that PGGM is prepared to pay for each investment category and what the minimum is that must be included in the term sheets. The Fee Protocol is applied on a 'comply or explain basis' and teams within PGGM are assessed in part on the basis of the correct application of the Fee Protocol. The Fee Protocol is evaluated every two years and gradually adapted in line with our long-term vision as explained in these *Guidelines for the Compensation of Financial Service Providers*.

Collaboration

PGGM wants improve the market in consultation with industry bodies. Within the legal framework in which we operate, PGGM wants to explore the option of forming a united front together with a number of other major investors in which we will agree to no longer accept certain fee structures. A large group with a relatively limited objective could be extremely effective.

Communication

PGGM will attempt to convey its vision to the market through conferences, literature and the wider press. This will need to take place in close collaboration with the relevant industry organisations. Collaboration and communication is particularly pertinent for improving market practices, but it can also prepare the market for the introduction of stricter requirements in terms of transparency.

Attention for transparency in due diligence

For due diligence of individual investments, PGGM will escalate its requirements in relation to compensation transparency. This will also be an important aspect of the strategy in relation to collaboration and communication. By 2020, PGGM will no longer make assets available (give commitments) to organisations which do not provide detailed insight into budgets and remuneration policy.

Continuation of the internalisation process

The path we have taken regarding ongoing internalisation will offer PGGM alternatives for investing via external managers and it will improve PGGM's negotiating position. In addition, internalisation presents PGGM with the opportunity to apply the vision regarding compensation, as reflected in these guidelines, more directly and more effectively within the organisation.

Increasing commitments to individual external asset managers

Larger commitments to individual external managers not only lead to reduced rates, but also offer the opportunity to exercise more influence on the manager. These advantages must be balanced with the advantages of diversification by working with several external managers on the basis of relatively smaller commitment.

Alignment of PGGM employees

PGGM has an internal remuneration policy that is in line with the principles of these guidelines. For instance, we have set maximum amounts to prevent excessive remuneration. We also apply clawbacks where necessary and we take non-monetary aspects into account in the remuneration structures; these aspects focus on the long term and on the interests of wider stakeholders. Finally, the impact on social and environmental issues is explicitly taken into account.

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