ALDERSGATE GROUP LEADERS FOR A SUSTAINABLE ECONOMY

Consultation on clarifying and strengthening trustees' investment duties

Aldersgate Group submission, July 2018

BACKGROUND

1. The Aldersgate Group is an alliance of major businesses, academic institutions, civil society organisations and cross-party politicians, which drives action for a sustainable and competitive economy. Our corporate members, who come from across the economy and have a collective global turnover of nearly £600bn, believe that ambitious and stable low carbon and environmental policies make clear economic sense for the UK.

2. In March 2018, the Aldersgate Group published a major report, *Towards the new normal: increasing investment in the UK's green infrastructure*, which set out key recommendations for government, business and investors to facilitate greater investment flows into critical green infrastructure needed to meet the UK's policy goals.[1] The report, which was based on extensive interviews with business and finance sector leaders, argued that asset managers and trustees should take longer-term risks into account when designing investment strategies. Taking such an approach can result in better investments more suited to the investment horizons of pension savers, such as investment in infrastructure that is resilient to extreme weather events and assets that are less at risk from future policy changes.

3. The Aldersgate Group was a member of the Green Finance Taskforce (GFT) and endorses its recommendations on the clarification of fiduciary duty and pension scheme member engagement. We strongly agree that taking proper account of the financial risks and opportunities that Environmental, Social and Governance (ESG) considerations pose is essential to enable the UK financial system to respond in a timely way to climate risk and clean growth opportunities.[2]

INTRODUCTION

4. We welcome the recognition in this consultation that despite The Pension Regulator's guidance, confusion and misapprehension over trustees' responsibilities with regards to ESG issues persist, and that good practice is far from universal. We further support the government's position that the proposals should not seek to direct trustees' investment or divestment decisions and to respect their primacy.

5. However, **we have remaining concerns that the proposals do not adequately tackle the lack of expertise that trustees have regarding ESG issues**. Anecdotally, the Aldersgate Group has found that trustees have not demonstrated a strong understanding of how ESG risks can have a financially material impact, meaning significant risks may be overlooked even within the context of these

[1] Aldersgate Group (March 2018) *Towards the new normal: increasing investment in the UK's green infrastructure*
[2] Green Finance Taskforce (March 2018) *Accelerating green finance*

proposals. Moreover, consultants relied upon by trustees still see ESG services as niche and only provide this at an extra cost, rather than engaging with long-term ESG issues systematically.[3] We are pleased to see that organisations such as the AMNT and UKSIF are making progress on the issue of how consultants advise on ESG risks, but this does not appear to go far enough to validate the consultation's expectation that "the range of instances where trustees conclude that there is no requirement for consideration of financially material risks, including those arising from ESG…to be limited and focused on very particular circumstances".

6. **We therefore seek clarification within the draft regulations that there is an obligation for trustees to be sufficiently knowledgeable about ESG risks to make informed decisions about financial materiality, and to challenge consultants regarding ESG issues.** In line with recommendation 20 of the GFT, investment consultants should have sufficient expertise and competency on ESG issues, including climate change, and should include ESG issues as a standing issue when advice is given.

7. Noting that the draft regulations do not align with the Non-Financial Reporting Directive definition of 'non-financial', we recommend greater alignment to reduce confusion amongst trustees.

CONSULTATION QUESTIONS

Accounting for financially material considerations and members' views

Q2: We propose to require all trustees of all schemes which are obliged to produce a SIP to state their policy in relation to financially material considerations including, but not limited to, those resulting from environmental, social and governance considerations, including climate change. a) Do you agree with the policy proposal? b) Do the draft Regulations meet the policy intent?

8. We welcome that the proposed regulatory changes intend to dispel confusion and give confidence in increasing capital allocation towards green and social impact investment. We are further glad to see clarity that trustees should take account of social and environmental considerations if they are financially material, and that trustees are not permitted to take no account of such considerations.

9. We support the proposal that trustees be required to state their policy on the evaluation of financially material considerations but **suggest that further guidance on this could be provided to clarify what Government understands by 'financially material', to reduce ongoing confusion regarding ESG matters**.

10. We also support the proposal to explicitly include climate change in the wording, as it poses the clearest systemic risk,[4] and are pleased to see acknowledgement that other environmental risks and opportunities may also be material. Whilst we believe

[3] UN PRI (2017) *Investment consultant services review*
[4] As set out by Mark Carney in his Tragedy of the Horizon speech at Lloyds, September 2015

that greater alignment with European developments on 'Sustainable' finance is desirable, we understand that the term 'sustainability' is liable to create confusion in this context and therefore support the clarity within the proposal.

11. Whilst it is true that not all ESG risks are exclusively long-term, we believe that "appropriate discretion over the period" should be reflected as appropriate timescales for the investment horizons. For example: 'risks and financially material considerations should be considered in a manner consistent with the profile and duration of a scheme's liabilities, noting that ESG risks do not exclusively apply in the long-term'.

Q3: When trustees prepare or revise a SIP, we propose that they should be required to prepare a statement, setting out how they will take account of scheme members' views. a) Do you agree with the policy proposal? b) Do the draft Regulations meet the policy intent?

12. The Aldersgate Group supports the proposal that trustees should make a statement within the SIP on how they take account of members views on financial and non-financial matters that they feel are relevant in developing investment policies. We reiterate that trustees should retain control of investment decisions and that their prime focus is to deliver a return to members over an appropriate investment horizon.

13. However, we believe that the current wording should be strengthened to state that pension trustees *should* (as opposed to "can") consult with beneficiaries on non-financial factors they want taken into account. We note that the '2 stage test' for considering ESG factors requires trustees to have a good reason to think scheme members hold concern regarding ESG issues. **For this test to be meaningful, it will be critical for trustees to have a robust process for understanding and engaging their scheme members.** Greater engagement from trustees on savers' views will ensure members' interests are considered, and better connect end investors with the investment chain. Trustees should not assume they know their members' interests without asking.

14. The SIP should also provide clear information to clients about the potential benefits and risks of incorporating such preferences, including the effect on the prospective return of the investment strategy. A clear statement will ensure that beneficiaries feel their views are taken seriously by trustees, whilst also managing expectations about how their views will be taken into account, being transparent that trustees are not required to act on any particular concern and will retain a focus on delivering long-term returns to a scheme's membership.

15. As the consultation agrees that it is "good practice for trustees to inform the design of investment strategies with an understanding of scheme members' views", the later statement that "we wish to avoid giving trustees any impression than investments should be made in line with scheme members' preferences" would be better phrased to reflect that **trustees should consider scheme member preferences in**

investment decisions provided there is no risk of significant financial detriment to the fund over an appropriate investment horizon.

16. Consultation with savers will be more fruitful with more widespread financial literacy. As such a nationwide financial literacy programme, for example through the secondary school curriculum, would be a complementary measure for government to consider.[5]

Q4. Do you agree with our proposal not to require trustees to state a policy in relation to social impact investment? If not, what change in legislation would you propose, and how would you address this risk of trustee confusion on this point?

17. The Aldersgate Group agrees that trustees should not be required to state a policy in relation to social impact investment. Whilst we agree that in many cases it will be appropriate for trustees to consider social impact opportunities within its investment strategy, this should be a discretionary matter, as not doing so does not present financial risks to the long-term value of pension schemes. We also agree that the requirement to consider financially material risks and opportunities which can enhance member returns, and the option to consider scheme members' views should be sufficient to give trustees the confidence to invest in social impact investment. This approach is therefore aligned with the government's intention not to direct trustees' investments.

Q5: We propose that trustees should be required to include their policy in relation to stewardship of the investments, (including monitoring, engagement and voting) in the SIP. a. Do you agree with the policy proposal? b. Do the draft Regulations meet the policy intent?

18. Moving beyond voting towards continuous engagement is an important component of stewardship to improve outcomes. For example, Legal and General Investment Management (LGIM) has taken an active stewardship strategy through its Climate Impact Pledge: it has committed to direct engagement with companies not addressing the long-term financial risks of climate change, through a combined approach of ranking, publicising and - if no improvement is seen within 12 months - divestment, to improve the strategies, governance and transparency of companies in its Future World Fund. LGIM'S approach is that active engagement will make its portfolio more resilient to climate change and environment-related policy changes, more successful in providing low carbon solutions to customers, and ultimately generate greater returns.[6] In June 2018, it removed eight companies from the Fund, and has pledge to vote against the re-election of the companies' chairs across its entire range of equity funds.[7]

19. We agree it is proportional to enhance and extend the requirement for DC and DB schemes with 100 or more members from making a statement of any policies on

[5] Aldersgate Group (March 2018) *Towards the new normal*
[6] LGIM (November 2016) 'ESG Spotlight' *Time to act on climate change: Engagement with consequences*
[7] Edie (13 June 2018) 'Legal and General divests from climate change 'laggards''

rights and voting to a policy on stewardship, but not make provision for schemes with 99 or fewer members in the near future.

20. However, we believe that trustees of default funds should also be required to include a stewardship policy within the SIP. With 11 million pensions in DC funds and 92% of those in default schemes[8], all requirements of the SIP should apply equally to default schemes.

Q6: When trustees of relevant schemes produce their annual report, we propose that they should be required to: - prepare a statement setting out how they have implemented the policies in the SIP, and explaining and giving reasons for any change made to the SIP, and - include this implementation statement and the latest statement outlining how trustees will take account of members' views in the annual report. a) Do you agree with the policy proposal? b) Do the draft Regulations meet the policy intent?

21. We support the proposals for trustees to explain how they have implemented the SIPs, including explanation for any changes, and for this to be included in the annual report. We agree this exercise will help to ensure the spirt of SIPs are well considered by trustees, as this will be critical to the efficacy of the proposals set out in this consultation.

[8] The Pensions Regulator (2017) DC trust: presentation of scheme return data 2016–2017