

# ClientEarth response to consultation

## A consultation on the Department for Work and Pension's proposals to clarify and strengthen trustees' investment duties

16 July 2018

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### 1 Introduction

On 18 June 2018, the Government published its final response to the Law Commission's report '*Pension Funds and Social Investment (Law Comm No. 374)*'. As part of this response, the Department for Work and Pensions ("DWP") launched a consultation (the "Consultation") proposing changes in relation to how pension trustees disclose their consideration of environmental, social and governance ("ESG") factors in their investment decisions, together with other key issues such as policies on stewardship and reflecting the views of pension scheme members. The proposals will be implemented through a new statutory instrument, the Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2018 (the "Regulations").

This document provides ClientEarth's general comments in relation to the Consultation, together with specific responses to Questions 1, 2, 3, 5, 6, 7 and 11.

ClientEarth is a non-profit environmental law organisation based in London, Brussels and Warsaw. ClientEarth's Climate Finance Project conducts research into the legal implications of climate change-related financial risk for a wide spectrum of market participants including companies, investors (including pension funds and banks), company directors and regulators. We also engage with and conduct advocacy with these stakeholders in relation to the specific and systemic risks of climate change.

**Please do not hesitate to contact Joanne Etherton, Climate Finance Project Leader (acting), at [jetherton@clientearth.org](mailto:jetherton@clientearth.org) for further information on anything contained in this response.**

## 2 General comments

ClientEarth welcomes the proposals and strongly supports the proposed requirement for trustees to set out explicitly within the Statement of Investment Principles (“SIP”) and within the default strategy, where applicable, how they take account of financially material considerations relating to climate change. These proposals represents an important step towards ensuring that trustees give due consideration to climate risk as a potentially financially material, rather than ethical, issue. By clarifying trustees’ legal duties the proposals will make it easier for trustees to ensure they are complying with existing legal standards and remove some of the confusion around the treatment of ESG issues, including financially material ESG issues such as climate change.

The proposed changes will encourage trustees, and other actors in the investment chain, to view climate change as a mainstream investment risk and make clear that a failure to consider climate related risks would mean falling short of trustees’ legal duties towards pension scheme members.

We also support the requirement for trustees to set out their policies in relation to stewardship of investments. This proposal will encourage trustees to become more active asset owners and engage with the range of possibilities for exercising ownership beyond shareholder voting rights, for example through direct engagement with investee companies. We feel it will be very beneficial for trustees to think broadly about how they might positively influence and enhance the long-term value of investee companies and therefore financial benefits for members.

We further support the proposal to publish schemes’ SIPs so that members can better understand what actions their scheme is taking on climate risk and other strategic investment decisions. Making the SIP automatically available to members, rather than only upon request as is the current standard, is an important step forward. This increased transparency will have the dual effect of encouraging engagement with scheme members and preventing the SIP from being a static and perfunctory document. Requiring trustees to produce and publish online an implementation report is a further commendable means of ensuring that trustees act on the policies set out in the SIP and have an opportunity to explain where they have deviated from the agreed approach. Providing a clearer framework for engaging with the views of members, in the form of a trustee statement, will further encourage a constructive dialogue between scheme members and trustees.

## 3 Responses to questions

**Q1. We propose that the Regulations come into force approximately 1 year after laying, with the exception of the implementation report, which would come into force approximately 2 years after laying.**

**a) Do you agree with our proposals?**

Yes, one year is sufficient time for trustees to review their SIP to ensure it is updated and in full compliance with the new requirements. Although changes to existing SIPs are likely to be

required, we consider that the new requirements reflect issues that trustees should already be considering as part of their current legal duties and so do not represent a significant burden on trustees.

Allowing two years for the publication of the implementation report will give trustees time to assess how they have taken action in line with the policies and principles set out in the revised SIP. On the other hand, we do not think that the implementation report should be published any later than two years after the amended Regulations come into force as it is important that members have the opportunity to benefit from the increased transparency it provides and that trustees begin closer monitoring of the SIP.

**b) Do you agree that the draft Regulations meet the policy intent?**

Yes.

**Q2: We propose to require all trustees of all schemes which produce a SIP to state their policy in relation to the consideration of financially material considerations including, but not limited to, those resulting from environmental, social and governance risks, including climate change.**

**a) Do you agree with the policy proposal?**

Yes, we strongly support this proposal. The drafting of the current Regulations is unclear as to whether trustees are expected to consider climate risk and we welcome both the clarity and the broad application of the proposed amendments. It is important that all financially material investment risks, including climate change, are properly considered irrespective of scheme structure.

**b) Do the draft Regulations meet the policy intent?**

Yes. In particular we support the approach taken to the definition of “financially material considerations”. The current drafting of the Regulations refers to “social, environmental or ethical” which is overly broad and conflates financial and non-financial considerations. Although it may be appropriate and desirable for trustees to consider non-financial factors in their investment strategy, the proposals provide welcome clarity on how these factors should be viewed in light of trustees’ overarching fiduciary duty to act in the best interests of members. Specifying that ESG considerations, including climate change, may encompass financially material considerations will prevent trustees from discounting these factors without due consideration. It is our view that, although trustees are under an existing duty to account for all financially material risks, it is necessary to emphasise that these risks may arise in ways that may not have been previously considered, and the draft Regulations therefore act in support of the current law.

The explicit inclusion of climate change as a key consideration within the broad definition of ESG is extremely helpful. Unlike some other ESG risks, climate change is a systemic risk that should be considered at all levels of investment, both geographic and sectoral. We frequently encounter trustees who misconceive that asset managers, acting under delegated authority, can address climate risk at the stock-picking level. However, given the systemic nature of the risk trustees

must set the strategic direction of the scheme and ensure that asset managers are instructed and incentivised to achieve the scheme's investment strategy.

We feel that it is helpful for trustees to consider financially material climate risk alongside other mainstream investment risks and that this will encourage scheme advisors to provide better advice to trustees to support them in their decision making.

**Q3: When trustees prepare or revise a SIP, we propose that they should be required to prepare a statement, setting out how they take account of scheme members' views.**

**a) Do you agree with the policy proposal?**

We agree that it is good practice for trustees to be aware of the views of members and to ensure that trustees can be put on notice of any potentially material issues raised by members that they may not have been considering. The proposed changes are welcome in that they provide an opportunity for trustees to engage with members while retaining their core responsibility for determining the scheme's investment strategy. Increased opportunities for members to understand how their money is invested and to communicate with trustees can only serve to improve the quality of pension provision in the UK and may even have the effect of increasing member contributions. The impact assessment for this Consultation refers to research by the Defined Contribution Investment Forum which found that 40% of members would contribute more to their pension if they knew it was being invested responsibly.

We support the inclusion of the language "in the reasonable opinion of trustees" as this creates an obligation for trustees to take reasonable steps to ascertain members' views without being overly burdensome. We support the Law Commission and the DWP in that we do not feel that it would be proportionate or practical to require trustees to invest in line with members' views. However, as the ultimate beneficiaries of the scheme's investments, members should have the ability to communicate their preferences to trustees.

**b) Do the draft Regulations meet the policy intent?**

Generally, yes. We agree with the Law Commission's guidance that the courts would expect trustees to focus on financial factors when considering how to act on the views of scheme members. However, it is likely to be helpful for both trustees and members to have some guidance on how members' views may be surveyed and accounted for. As set out in the Consultation, the statement on member views will provide a structure for trustees when considering whether the views of members should be taken into account in an investment decision.

As set out in the impact assessment, the proposal does not require trustees to create a policy on taking into account members' views and trustees may instead choose to state that they do not take members' views into consideration. The proposal therefore contains sufficient flexibility for schemes that do not currently feel it is appropriate for them to survey members, whilst providing a framework for the majority of schemes to enhance engagement with members.

**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?**

ClientEarth does not propose to answer this question.

**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?**

Yes, because stewardship in its broadest sense (including monitoring and engagement with investee companies, as well as voting) is a vital part of protecting and enhancing the value of pension investments. The proposals are helpful in that they seek to broaden the way in which trustees may think about stewardship and, in doing so, emphasise that there are a range of tools available to schemes irrespective of size or the nature of investments held.

We support the statement made in the Consultation that trustees should, as far as possible, ensure that stewardship is properly exercised throughout the whole length of the investment chain. This should include reviewing mandates with asset managers to make sure that they properly reflect the trustees' policies on stewardship and that, where possible, voting rights are disaggregated to allow for schemes to vote their own shares rather than have votes exercised by the asset manager with only limited scope for engagement by trustees.

**b. Do the draft Regulations meet the policy intent?**

Yes.

**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?**

Yes, we support these proposals for two reasons. Firstly, requiring trustees to report on why they have revised policies and how they were implemented in practice will increase the level of accountability that trustees have for the scheme and provide members with valuable insight into the governance process and any factors that may have caused trustees to deviate from agreed policies. Secondly, the process of compiling an implementation statement will encourage trustees to engage with the impacts of their policies and provide a mechanism to reflect on whether they are achieving the scheme's investment aims.

Along with the requirement to publish the SIP, the requirement to produce a statement on how the SIP has been implemented will help ensure that it becomes a more meaningful document, which is helpful to pension scheme members and not merely a 'box-ticking' exercise.

We support the focus on requiring trustees to positively report on how they have implemented the scheme's SIP, rather than the focus of the current rules, which is that trustees need only report on where they have made investments in breach of the SIP.

**b) Do the draft Regulations meet the policy intent?**

Yes.

**Q7: We propose that trustees of relevant schemes should be required to publish the SIP, the implementation report and the statement setting out how they will take account of members' views online and inform members of this in the annual benefits statement.**

**a) Do you agree with the policy proposal?**

Yes, as already referred to, improving access to information for members is an important means of increasing engagement between schemes and members and it is likely that increased engagement will help to drive up standards among trustees. Improving the depth and quality of information that is available to pension members on issues that may affect the long-term performance of a scheme, and therefore their retirement benefits, will assist people in making informed and appropriate decisions. We are very supportive of the shift towards making information automatically available to members, rather than on request, and this seems both a reasonable and proportionate approach given that information can be easily hosted online.

**b) Do the draft Regulations meet the policy intent?**

Generally, yes. As members of defined contribution schemes bear the risk of investments made by the scheme they have the greatest interest in understanding trustees' policies on key investment issues. However, we also feel that it is important that scheme members have access to the same information and protections, irrespective of scheme structure, so would support the future extension of this requirement to defined benefit schemes.

**Q8: Do you have any comments on the business burdens and benefits, and wider non-monetised impacts we have estimated in the draft impact assessment?**

ClientEarth does not propose to answer this question.

**Q9: Do you have any other comments on our policy proposals, or on the draft regulations which seek to achieve them?**

ClientEarth does not propose to answer this question.

**Q10: Do you agree that the revised Statutory Guidance clearly explains what is expected of trustees in meeting their duty to publish the SIP, implementation statement, and statement of members' views?**

ClientEarth does not propose to answer this question.

**Q11: What evidence or views do you have of how well the other requirements in the SIP are working? What areas for further consideration and possible future change would you suggest?**

In relation to the requirement for trustees to seek the advice of a suitably qualified person when compiling the SIP, we would suggest that the Government considers further cross-departmental/regulator work looking at how different actors in the investment chain are operating together and within the same rules and objectives.

Beyond the formal requirements of the SIP, guidance from the Pensions Regulator requiring pension schemes to report on climate risk in line with the Task Force on Climate-Related Financial Disclosures ("TCFD") would ensure that a standardised framework for reporting on climate risk was embedded within internal organisational processes. This in turn would assist pension trustees with identifying and mitigating those risks that their portfolio is particularly exposed to. Encouraging pension schemes to report on their climate risk exposure in line with the TCFDs would follow the recommendation of the Environmental Audit Committee's final report, which requested that regulators issue guidance to avoid the need for new legislation.<sup>1</sup>

London, 16 July 2018

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<sup>1</sup> Greening Finance: embedding sustainability in financial decision making, Seventh Report of Session 2017-19, 23 May 2018