Consultation on Clarifying and Strengthening Trustees' Investment Duties

Established in 1921, Hymans Robertson is one of the UK's longest established independent firms of consultants and actuaries. We work with a wide range of trustee defined contribution and defined benefit clients providing advice on a range of investment strategy, implementation and governance issues. Responsible Investment is an area of growing interest across our client base and the concepts of Sustainable Investment, recognising the potential financial impact of ESG factors, and Effective Stewardship underpin our approach to this topic.

We are therefore broadly supportive of the Government in addressing the recommendations of the Law Commission and proposing changes to the Investment Regulations. The ambiguity in the current regulations has been a long-standing barrier to trustees being prepared to address the topic of responsible investment. Clarifying the need for trustees to consider all financially material factors in investment decision making, regardless of their source, is welcome.

We do however recognise that the proposals will result in costs to trustees and it is important that these costs are more than matched by benefits to all stakeholders in the form of improved governance. We have concerns about the pace of implementation and the proposal that money-purchase schemes be required to place documents in the public domain, both of which could result in greater costs and divert trustees attention from other issues. We also identify a need for further clarification and guidance in some areas, such as the thresholds for financial materiality and the extent of trustees' obligations with respect to members' views,

Q1. We propose that the draft 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?**

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

We have concerns that the proposed timeframes for implementation are too short.

To give effective consideration to these issues in line with the policy intent, trustees need to follow a process of education, policy development, refinement and implementation to reach an appropriate position for their scheme. Such a process is likely to span several trustee meetings and must be accommodated alongside all other trustee business over this period.

We also note that the timetable for implementation allows for the statement on member views to be produced at the next revision of the SIP after 1 October 2019. Given that the requirement for the SIP to be reviewed every three years, may mean that implementation reporting is required **before** a statement on member views is produced. Government should provide clarification on this issue.

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?**

We agree with policy proposal. As noted in paragraph 2.4 of the consultation, one of the fundamental problems stemming from the 2005 regulations has been the conflation of ethical considerations with environmental and social issues. This has generated confusion amongst trustees and created a barrier to trustees giving effective consideration to relevant, financially material issues and we therefore welcome steps to improve and create consistency in the language pertaining to ESG issues.

A further barrier to the effective consideration of ESG issues by trustees is a focus on the short-term. Paragraph 1.30 of the consultation highlights the relevance of timeframe to the consideration of financially material risks, noting that the trustees of a scheme close to wind-up may reasonably conclude that risks may not crystallise over a short timeframe. In contrast, such risks could be considered more financially material for trustees with an investment horizon measured in decades.

We agree with the definition of financially material considerations set out in the draft Regulations and believe it appropriate that trustees should take these issues into account. However, by simply amending regulation 2(3)(b)(vi), the draft Regulations implicitly demote consideration of the issues. We propose that this regulation appear earlier in the paragraph given other aspects of regulation 2(3)(b) address the means through which trustees deal with financially material risks, i.e. choice of investments, diversification etc.

Further, the draft Regulations state that the list of financially material considerations "**is not limited** to environmental, social and governance considerations (including climate change)". It may be that those trustees who are more inclined to adopt a compliance approach will feel they have licence to stop there, rather than considering the issue more broadly, as is the policy intent.

The draft Regulations do not define what is meant by "financially material", leaving this a matter of judgement for individual trustee boards. Whilst what is financially material will differ both between schemes and between defined benefit and defined contribution arrangements, this ambiguity retains a barrier for trustees. We propose that Government consider providing some level of additional guidance on its interpretation of "financially material".

We note that the IORP II Directive identifies other considerations in addition to climate change. It will oblige most trustees to have a system of governance that includes consideration of environmental, social and governance factors in investment, and that those that do will have to conduct an own-risk assessment that includes '*risks related to climate change, use of resources and the environment, social risks and risks related to the depreciation of assets due to regulatory change.*'

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?**

We agree with the policy proposal although believe this has the potential to create significant practical and cost concerns for trustees.

As with any element of investment policy, we note that this requires consultation with the sponsor, and it would not be unreasonable to expect trustees of DB schemes in particular to consider sponsor policy on ESG issues and climate change. In DB schemes, where investments support member entitlements and the balance of cost falls on the sponsor, it is appropriate that trustees have scope to state "not at all", as implied by Paragraph 2.33 of the consultation. However, it is also appropriate for trustees to then set out their reasoning, as required by the draft Regulations.

For DC schemes, where there is a clearer link between members and the underlying investment, we believe it more important that trustees consider members' views. An (unstated) objective of this policy proposal may be to increase member engagement on pension matters which would be welcome and, to that end, the proposals broaden the topics on which trustees may interact with members. However, in order to simplify administration and manage cost concerns, we would expect trustees to make use of existing communication channels.

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?

We agree with the proposal. We believe the requirements of fiduciary duty in DB schemes and the consideration of member views are sufficient to accommodate social impact investment at this time.

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?

We agree with the policy proposals. We support the FRC statement that stewardship is far broader than voting and believe it to be relevant across all asset classes, regardless of the means through which investments are made. We therefore support the inclusion of investment managers in the definition of "relevant persons" and the comments in paragraph 3.14 on indirect engagement.

Paragraph 3.13 notes that stewardship covers three areas: voting, engagement and monitoring although the intent of including "monitoring" within this list is not clear. Without clarification, there is a risk that monitoring simply becomes another box-ticking exercise which whilst perhaps appropriate in certain circumstances (smaller/low governance schemes), may be counter to the policy intent. Government should consider providing further guidance for trustees on this matter.

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?

We agree with the policy proposal. The SIP is an overarching governance document and it is appropriate that trustees refer back to it when assessing their performance. Requiring trustees to prepare a statement about how they adhered to their SIP, rather than stating how they have deviated from the principles means the focus will be on positive aspects of trustees' roles and responsibilities.

We do however have concerns about the use of 100 members as a cut-off for reporting and believe this to be a particularly low threshold which could result in disproportionate costs to the benefits gained. We propose a higher membership threshold be considered.

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?

b) Do the draft Regulations meet the policy intent?

We disagree with the policy proposal. The direct and indirect costs of sharing information with non-interested parties through publication more than offset the benefits of sharing best practice which can be addressed through industry forums, external advice and regulators.

We agree that the trustees of relevant schemes should make the documents more readily available to members by publishing this information online, thereby increasing transparency for scheme members, which we welcome. However, we see no reason for placing this information in the public domain and question both whose benefit this will ultimately serve and consequently the ability for the proposals to achieve the policy intent. We therefore propose that the requirement to place the documents in the public domain be voluntary, rather than mandatory.

Paragraph 1.26 states that the "proposals are not intended to give any support to activist groups for boycotts or divestment from certain assets" yet such groups are likely to be the principal users of such information. There is a risk that by placing the information in the public domain, trustees will be increasingly subject to campaigns from lobby groups.

We believe it unlikely that the outcome will be to drive up standards, but rather that this will result in trustee time being taken up responding to such groups in order to avoid reputational risk, instead of spending valuable time managing and governing the scheme on behalf of members. Further, in order to mitigate such concerns, there is a risk that trustees simply follow a compliance approach, providing only a minimum level of information to members which would be counter to the policy intent.

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?

The impact assessment does not consider the opportunity cost of implementing the proposals. Where trustees operate with fixed budgets, cost incurred on governance changes may mean that money is not spent elsewhere. By extending the timeframe for implementation of the regulations as noted in our response to Question 1, schemes will be more able readily able to accommodate the changes within their broader work plans.

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

A number of pension schemes have been established which provide defined benefits, albeit subject to a "money-purchase underpin". For example, many pension schemes contracted-out on a protected rights basis from April 1997 giving rise to such an underpin. We do not believe that consideration has been given within the proposals to schemes in this position and it is therefore unclear how they will be treated. These schemes are typically much more aligned to pure DB arrangements than DC schemes. We do not believe they should be subject to the broader obligations for money-purchase schemes.

Where the principal benefit payable from the scheme is defined benefit in nature and members do not have access to a clearly defined "money purchase pot" or the money purchase benefits are calculated by reference to the overall return on the scheme's assets, then such schemes should be treated as "pure DB". We recommend that Government clarify the position in this regard.

Separately, we believe that one consequence of the proposals may be to push more trust based DC schemes towards Master Trusts, thereby increasing the level of assets in these arrangements. Not only does this move decisions on investment principles one step further away from members, to the extent that the default investment arrangements make use of similar factor driven strategies, one unintended consequence may be increased market inefficiencies.

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?

Whilst the updated Guidance sets out the requirements for trustees, we believe there are areas where this Guidance could be improved as set out in this response.

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?

The SIP is a worthwhile policy document for trustees, however more could and should be done to ensure the statements included in the SIP are applied consistently to trustee decision making. We believe that the implementation of the principles recorded within the SIP should be the focus of trustees' attention.

Overall, the SIP should remain a simple reference document as we recognise that detail and depth can add complication which may get in the way of effective governance. The principles that a SIP contains should facilitate nimbleness, which is an argument for a 'less is more' approach.

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For and on behalf of Hymans Robertson LLP

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