Consultation on clarifying and strengthening trustees' investment duties

The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2018

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?

The stated purpose of the new legislation is to:

- encourage trustees to take account of financially material risks, whether these stem from investee firms' traditional financial reporting, or from broader risks covered in non-financial reporting or elsewhere;
  - Comment – yes this aim is consistent with the trustees' priorities and focus. Most will be doing this already with advice, via their asset managers. It is the case that regular performance reporting by both companies and asset managers tempts the impatient investor to focus too much on the short term. It is right that this should be discouraged amongst trustees who are too often told that short term volatility equals risk when this is almost always irrelevant for pension investments.
- Hold investments in members' best interests through voting and broader stewardship activities, such as monitoring, engagement and sponsoring or co-sponsoring shareholder resolutions
  - Comment - Yes, something to be encouraged and most effective with large schemes. Small schemes can elect to work with asset managers who engage actively with the entities in which they invest (LGIM sets a good standard here)
- have an agreed approach on the extent, if at all, to which they will take account of members' concerns, not only about financially material risks such as ESG, including climate change, but the scheme's investment strategy as a whole; and
- use the SIP as a real, effective and regularly-reviewed guide to investment strategy and not as a generic 'box-ticking' document.

Comment on these last two:
The government has decided that trustees are not taking ESG including climate change or the views of members sufficiently into account in their investment decisions. They therefore propose to mandate additional language in scheme SIPs to force trustees to take into consideration these factors to a greater degree than today and to report on the actions taken (and, in the case of DC, publish them). Whilst it is clearly very important that trustees consider these risks alongside all the other investment risks (and failure to do so represents an oversight), it feels as if a political agenda is at work here. These risks are of an extremely indeterminate nature when it comes to the actual decisions the average pension fund has to make as is amply demonstrated by the 30 pages it took to outline this slightly revised approach. Taking members views into account is also fraught with difficulty on a practical level. The consultation document is at pains to note that all investment decisions remain at the trustees' discretion (taken with suitable advice) but then seeks to impose requirements (upon which they must report) to consider investing in a certain way. If trustees are not considered competent to take into account all risks and opportunities in the context of today's investment climate, this raises a separate issue.

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Could not this whole topic be addressed by tPR issuing guidance that it believes trustees are not taking ESG including climate change sufficiently into account in their long term risk evaluation and that they expect these matters to be included in a balanced consideration of an investment strategy that is in the best interest of the members.

This then feeds through to the investment consultants who can drive asset manager behaviour. For the largest schemes (small in number) they can (and already do in some cases) direct segregated mandates or direct investments to an increasing degree that take into account ESG and climate change (e.g. renewable energy investments). For other schemes, the way in which meaningful change will take place is when asset managers know that investment consultants won't put their pooled funds on a buy list unless they can show that they are addressing these topics proactively.

Taking members' view into account is also an admirable idea in theory but difficult to implement in practice and, of course, only relevant in practical terms with DC schemes. In a perfect world, DC members would be highly engaged with the subject and an easy consensus would emerge with respect to one or two themes that could be easily converted into an investment approach providing long term value for members. The most likely scenario is that few members will express their views and that those who do will have strong and divergent priorities that are not easily translatable into an investment approach. DC schemes will increasingly be Master Trusts (presumably GPPPs are excluded here?) with membership from very divergent backgrounds. What if vocal members call for climate priorities to trump simple pursuit of investment returns but others want investment returns to be the absolute priority? Catering for divergent views with a multitude of fund options is expensive to run and risks confusing members 90% of whom are generally not investment savvy. Trustees may also feel directed to make poor investment decisions because they have a regulatory duty to incorporate perceived member views. The more rules made about the way trustees must behave, the more trustee investment decision-making will be about box ticking – especially if a fine is the result of failing to tick a box.

Generally, trustees, guided to a greater or lesser extent by advisers, will make educated decisions regarding investments and will take into account the long term prospects for investment notwithstanding continued efforts by assets managers to promote expensive short term strategies to control volatility. To the extent that there is guidance from tPR to consider certain elements in scheme management, this can often replace considered holistic decision making. The danger with the initiative is that, notwithstanding assurances that it remains the trustee decision where to invest, the exhaustive explanations about how trustees must consider ESG including climate issues will encourage trustees to tick this box even if this is in real danger of eroding returns required to fully fund the scheme or create unbalanced portfolios. Of particular concern is that vested interests have suggested that trustees "begin or increase the allocation of capital to investment opportunities such as unlisted firms, green finance and social impact investment". These investments have generally had a poor track record of returns and are often illiquid and might do real damage to recovery plans. Trustees should not be influenced by the political and personal agenda of others.

It is, however, right that trustees should apply increasing pressure on their asset managers to consider good governance as a key investment criterion. Well governed companies will have a diverse board, ethical employment practices, heightened awareness to their social impact and be conscious of their longer term footprint on the health of the planet. They will also be increasingly aware of the public reputational advantage of an ethical management philosophy. Crucially, though, only they will know what makes sense in the context of the market position of their company. It is futile to suggest that trustees should form a view, perhaps informed by members of what individual companies' strategies should be around climate change, for example. In the vast majority of cases, pension schemes are invested in pooled funds comprised of investments in over 100 different entities. What trustees can do is select investment managers based on their adherence to strong ethical standards in their asset selection and their active engagement to bring about positive change in the companies where they already invest (or might invest if corporate behaviours improve to prescribed levels).

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

This consultation is enormously well intentioned driven by the undeniable fact that, if a substantial proportion of the pension assets in the UK were invested for the good of our society and the wellbeing of the planet, it could bring about better corporate behaviours and this would drive a positive impact in these respect. Trustees are also aware that they are long term investors on behalf of their members many of whom (especially in the DC world) will want a better world for themselves in 50 years and in 100 years for their children.

The problem arises in how to bring this about. Legislating to force pension schemes to invest in certain way contradicts trust law and, trying to get around this fact (as this proposal does), is like asking the queen to direct the government over Brexit. Yes, she might do a good job but it's not something she's allowed to do.

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?

No, this wording makes it clear to trustees that they must report on ESG and climate change as a minimum. Having no mention in the requirements of other material considerations affecting members that do not tick these boxes will mean that Trustees' investment priorities will be "directed" which contravenes trust law and this proposal acknowledges repeatedly cannot happen.

b) Do the draft Regulations meet the policy intent?

If, integral to the policy intent is acknowledgement that trustees must make their own investment decisions, then, no, it does not. If the intent is to direct the trustees' actions notwithstanding the inconvenience of trust law, then, yes, it does.

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?

No. Where trustees have reason to form a view on the likely views of the membership, they should already reflect these, when practical, in investment decisions. When the consultation says "we wish to avoid giving trustees any impression that investments should be made in line with scheme members' preferences" but then spends the rest of the section trying to achieve just that, it points out the futility of this proposal. Creating additional regulation to force trustees to incorporate new language in the SIP then report out on it not only creates significant additional expense but is clearly designed to skew investment decision-making.

b) Do the draft Regulations meet the policy intent?

The policy intent contradicts itself and so do the proposals so, on that basis, they are at least consistent

Q4. Do you agree with our proposal not to require trustees to state a policy in relation to social impact investment?

Yes – this is a changing and nebulous topic and policies would need to be vague.

If not, what change in legislation would you propose, and how would you address this risk of trustee confusion on this point?

The trustees are only confused because of contradictory guidance in the past. Guidance should be clarified to state that there is a view (by government?) that many trustees are not taking enough account of ESG and climate change in their investment decisions and they should be encouraged to do so. As it happens, with renewables suddenly becoming very price competitive, sustainable decisions will be ever easier to make (even Shell is vowing to half its carbon footprint).

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?

If it really is necessary to instruct trustees how to write a SIP then this policy is sensible as it reflects good practice across the investment spectrum. I'm still not sure that it's the trustee duty to instil corporate governance practices such as these which the government, separately, has the power to direct; however, there will by private market and non-UK investments that would fall outside the power of government so it's right that investors should play a role.

b) Do the draft Regulations meet the policy intent?

Subject to the reservations above, 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?

In part. It is reasonable for trustees to be required to set out how they implement investment policy and the reasons for any changes to investment offerings (DC) or strategy (DB). I don't agree that they need to report on implementing a strategy imposed upon them by government or members with which, in law, they have no obligation to comply.

b) Do the draft Regulations meet the policy intent?

Subject to the answer in a) above, yes - but avoid the current obsession with fines. They merely skew trustee priorities toward box ticking rather than spending the governance budget on securing good member outcomes.

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?

I agree that the SIP should be published so it's fully accessible to members. I also believe that, if relevant, it can include reference to member views. I don't agree that it MUST set out member views as, again, this undermines balanced decision-making which contravenes trust law.

b) Do the draft Regulations meet the policy intent?

No, because of the compulsion element

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?

Even if the proposals here didn't contravene trust law, they would be heavy handed and costly. The investment consultants will be celebrating the prospect of all the additional advisory fees that they will earn and the scheme lawyers will profit substantially as trustees take ongoing advice and assurance on how to stay on the right side of trust law.

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

This is clearly driven by the current fashion for ESG and climate change topics. This is not to say they aren't very important issues (as are many others) but the industry is already plagued by directives driven by fashion (c.f. knee jerk responses from BHS or Carillion). Trust trustees to be responsible. If they are, they will be addressing these topics, if not, they're not doing their job.

Finally, this lays the groundwork for decades of interference on investment strategy to suit the tastes of the most vocal. Trustees can be reminded about current thinking with respect to best practice in making investments – they cannot be mandated to pursue a prescribed investment approach and, potentially, fined if they do not.

As already highlighted the key concern is the added cost from advisory fees this policy will lead to. Larger schemes have the advisory budgets and the ability to consider ESG requirements in detail. Smaller schemes should be spending their limited budgets on advice on the appropriate asset allocation and diversification required to mitigate the funding risks they face. This often leads to allocations to pooled passive equity funds, reducing the governance burden of monitoring active equity funds, which diversify the equity risk but the trustees have no ability to shape the ESG requirements. The funding and diversification risks far outweigh the ESG risks in these scenarios and this is where smaller schemes should be focusing their limited budget.