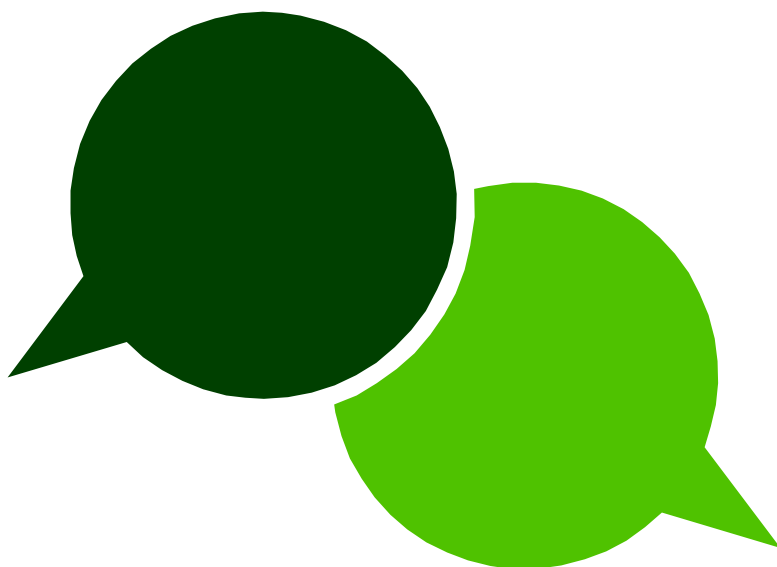


Department for Work & Pensions consultation on clarifying and strengthening trustees' investment duties

Response from Cardano Risk Management Limited

July 2018





Overview

We set out our response to the Department of Work & Pensions (DWP) Consultation on behalf of Cardano Risk Management Limited (Cardano').

Whilst we welcome the initiative to help clarify trustee responsibilities, some aspects are better suited to DC schemes than DB schemes.

We are concerned that the requirement is very broad and will result in a significant additional governance burden as trustees will need longer than anticipated to assess these issues and establish how best to reflect them.

The DWP should support trustees with additional guidance to help them ensure proportionality.

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About Cardano

Founded in 2000, Cardano is a purpose-built, privately owned specialist focused on integrated management of pension schemes' biggest risks: funding, investment and covenant. That's all we do. For the avoidance of doubt, we are not part of an employee benefits group, an actuarial firm, an insurance broker or a global asset gatherer with diverse lines of business and dissimilar clients. We are, therefore, less encumbered by conflicts of interest and organisational complexity, enabling us to offer specialist services of unusually high quality to a select group of clients.

We have a purpose beyond profit:

- **WHY?** We believe in a fair society in which financial services improve our quality of life
- **HOW?** We want to contribute to such a society by fighting for a fair and robust financial system that benefits all stakeholders
- **WHAT?** We strive to deliver better and more secure financial outcomes for our clients in a realistic and responsible way

Cardano employs 170 people based in London and Rotterdam to serve clients with assets of over £120bn. In London, 100 professionals serve 27 UK defined benefit pension schemes with assets of over £50bn. Our services include investment consulting, fiduciary management and implementation of derivative overlays.

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Chapter 1: Background and overview

1. 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.

Do you agree with our proposals?

Yes.

Subject to the legislation being passed as currently planned, this a reasonable timeframe for trustees to plan and prepare for, with the help of their Advisors.

For the majority of trustees, we would envisage related work and discussions spanning several meetings. The potential requirement to liaise with the membership means that a shorter timeframe would be unworkable.

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

Yes, we agree with the timescales set out.

Chapter 2: Accounting for financially material considerations and members' views

2. 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.

Do you agree with the policy proposal?

Yes.

We see this as an appropriate extension of the current requirements, which does help to clarify trustee responsibilities and as such, should ultimately be welcomed. We note however the challenge of preparing a policy which is broad enough to apply to any financially material consideration whilst remaining specific enough to be deemed meaningful. This is a notoriously subjective area, meaning it is possible to formulate a policy that leads to no actual change in behaviour. Alternatively, some trustees will allot a disproportionate amount of time to trying to measure and manage these risks, at the risk of neglecting even bigger financial or funding risks.

One could debate at length whether climate change should be separately earmarked or not, but on balance, we recognise the logic of doing this. It is important that, by being more granular on this risk, this is not seen as a tacit endorsement of 'off the shelf' low carbon or green energy funds, without fully considering their potential limitations. Clarity should be provided by the DWP to prevent this.

Do the draft Regulations meet the policy intent?

In part.

The draft Regulations do clarify that proper consideration of ESG issues is required of trustees. We are, however, concerned that the requirement is very broad and will result in a significant additional governance burden as trustees will need longer than anticipated to assess these issues and establish how best to reflect them. The DWP should support trustees with additional guidance to help them ensure proportionality.

In addition, it is clear that the intention is to amend the requirements for the default strategy and SIP. Changes to the requirements of the SIP are set out, however, it is not apparent in the draft amendments what is being proposed for the default strategy.

3. 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.

Do you agree with the policy proposal?

Yes, but only for DC schemes.

This is a reasonable request of the trustees where members have a money purchase benefit and there is generally more scope in DC arrangements to offer different choices to members with different preferences.

However, particularly for DB Schemes there remains a genuine risk that it creates a false impression for members of where responsibilities lie, or leaves trustees open to pressure from a minority of the membership who hold strong views.

Many trustees will agonise over how best to formulate this statement, canvas member views and reflect upon those views as part of an already busy workload. However, in most cases it will be unlikely that the trustees can confidently articulate a set of overarching member preferences and therefore represents additional work (and potentially cost) for no change in approach (because stage 1 of the 2-stage test will not be deemed to have been met).

Additional guidance to support the Regulations should help ensure Trustees spend a proportionate amount of time on this area.

Do the draft Regulations meet the policy intent?

No.

We note that whilst the two-state test is not referenced in the Regulations, it creates a 'get out of jail' mechanism – it will almost always be possible to argue it has failed.

In DB, we would argue the sponsor's view should also be explicitly included in trustees' considerations, as it is ultimately responsible for meeting the cost of the benefits. This is consistent with the current requirement to consult with sponsors, but any new legislation needs to be clear that additional requirements in relation to members do not conflict with this.

In DC, members should be offered the opportunity to transfer to an alternative pension arrangement if unhappy with the policy set out – why hold the majority hostage to a potentially vocal minority (as well as cause trustees an additional burden)?

4. 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?

Yes.

This is a fledgling area for institutional investors, with measurement and management of the relative benefits and risks a challenge for trustees and advisors alike.

The door is open for those who wish to consider it, but it is right that this is covered by the broader 'ESG' banner at the current time and not specifically carved out.

The proposed requirement is to address those factors deemed material. If it is not deemed material by the trustees, then there should be no need to mention.

Chapter 3: Stewardship of the investments

5. 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.

Do you agree with the policy proposal?

Yes.

This is helpful clarification and already included by many trustees. It should encourage trustees to expand current policies to cover the full range of stewardship activities and make clearer that delegating responsibilities to a third party does not divorce the trustees from the ultimate responsibility to act as stewards.

Where the trustees have no ability to actively influence the stewardship, possibly as a result of their choice of investment and/or implementation option (e.g. investing in a pooled index-tracking fund means that you effectively agree to the fund manager's approach or if implementing via futures, there is no ability to vote on the underlying stock), then the trustees should be encouraged to make these limitations clear. There is no use having a detailed policy when it cannot be implemented.

Do the draft Regulations meet the policy intent?

Yes.

Chapter 4: Improving the quality of the SIP

6. 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.

Do you agree with the policy proposal?

No.

Whilst we support inclusion of a statement relating to member's views for DC schemes, it is hard to see what an implementation statement would add, over and above the member newsletter and Chair's statement. It would be more efficient to require any specific comment on both member views and implementation to sit within the existing Chair's Statement.

Do the draft Regulations meet the policy intent?

Yes.

7. 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.

Do you agree with the policy proposal?

Yes (aside we question the worth of the separate implementation report as noted above).

Given Regulations are already in force which will require the logistical capability to put documents online, this appears to us to be a logical extension.

We note however that putting the SIP and other documents online will likely lead to the creation of a series of sanitised, potentially copy-cat documents rather than documents truly reflecting the characteristics of the specific scheme, which goes against the intention. The Pensions Regulator could monitor these documents over time and challenge any convergence as it emerges.

Do the draft Regulations meet the policy intent?

Yes.

Chapter 5: Penalties, impacts, Guidance and the wider SIP

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

We believe the time and financial costs for trustees are significantly underestimated, and the majority of trustees will devote significantly longer than anticipated to trying to address these changes properly. Whilst greater and more sincere consideration of these issues is to be whole heartedly encouraged, it should not be at the expense of other areas (such as funding, covenant, risk management, etc), which all have even higher priority. Some additional guidance on proportionality and best practice could be very helpful, particularly for small to medium sized schemes who typically have less budget for using external advisors to support their decision-making processes.

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

We support the intention and welcome the additional clarification of what trustees' fiduciary duty in relation to ESG entails. However, the wording remains broad and may not lead to much tangible change in behaviour.

10. 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?

Yes.

11. 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?

We remain surprised by the number of Schemes we encounter who do not have an overarching, quantitative objective for their investments in their SIP – either in terms of return or risk. As funding regimes are increasingly prescribed, it seems odd that all DB trustees don't have a specific target to aim for, other than 'to meet the benefits as they fall due'.

We would advocate for the SIP to include more explanation about the DB trustees' approach to Integrated Risk Management, starting with specifically how the investment performance links in to funding goals and the assessment of covenant risks.

DC SIPs in particular, seldom have clear, quantifiable objectives. This lack of clarity means that it is difficult for members to understand what the trustees are seeking to achieve on members' behalf, let alone whether this has been achieved. We believe that a greater focus on clear and quantifiable objectives would better serve DC members than any other considerations in a SIP.



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