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FAO: Sinead Donnelly and Vicky Bird
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PENSIONS.FIDUCIARYDUTY@DWP.GSI.GOV.UK 12 July 2018

Dear Ms Donnelly and Ms Bird,

Here follows Hermes Investment Management's response to the Department for Work and Pension's Consultation on clarifying and strengthening trustees' investment duties: The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2018

1. Preamble

Hermes Investment Management is an asset manager with a difference.

We believe that, while our primary purpose is helping beneficiaries retire better by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Hermes is majority owned by Federated Investors, Inc (Federated), a leading US investment manager with $392.2 billion assets under management. BTPS retains a minority stake, alongside members of Hermes' management. This relationship offers a strong global platform as both firms share a commitment to delivering client-centric investment returns responsibly.

We offer clients access to a broad range of specialist, high conviction investment teams with £33.6 billion assets under management. In Hermes EOS, we have one of the industry's leading engagement resource, advising on £330.5 billion of assets.

Hermes Investment Management welcomes the clarity these proposals will bring to the law regarding fiduciary obligations in relation to material environmental, social and governance (ESG) issues. We welcome the focus on requiring pension scheme trustees to consider the impacts on their investments from changing environment, corporate governance and social trends – including the explicit focus on climate change.

We also welcome the fact the proposals clarify regulations to strengthen trustees' stewardship duties, including company and public policy engagement, voting and controversy screening. We believe all these tools need to be deployed by an effective steward.

There is limited public information on the cost overhead associated with such stewardship activities. Based on the stewardship service which Hermes EOS provides for circa 40 stewardship clients the average cost of providing stewardship services is between 0.3 to 0.5bps[1] and for an individual client can range between 0.2 and 2bps depending on their size and the level of service provided. As the cost is shared across 40 clients, the cost for any single institution developing their own stewardship resource would be significantly higher than this.

Finally, we welcome the proposals for trustees to be expected to have a policy on how they take account of members' views, such as on social impact, when investing their savings with some caveats. The approach the consultations take, the framing of questions and level of interest and expertise of members will all have a bearing on the outcome of such exercise and so could lead to perverse outcomes. As such it would be useful if government were to issue some guidelines on best practice in undertaking such member consultations – and what level of obligation the pension fund has to take these matters into consideration (for example around materiality and appropriateness tests).

2. Consultation question responses

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?

Yes we agree that the timescales proposed are proportionate and reasonable and support them.

We fully support the proposals and agree that as set out they deliver a framework for appropriate Trustee-level discussions and decision-making processes in relation to ESG-integration essential to the long-term interest of beneficiaries. The importance of this clarified expectation that investors should shift from a tendency to focus on financial returns in the short-term to one that will help deliver a retirement income in a society worth living in can't be under emphasised. As such we welcome the proposals and agree they are an important step forward to deliver the policy intent of reassuring trustees that they can and

[1] In 2017, Hermes EOS revenues were £8.3m (Source: Hermes EOS Statutory Accounts 2017). In 2017, we represented approx. £350bn of Assets under Advice (AUA) during the year (Source: Hermes). Hence the average cost of providing stewardship services was ~0.4bps.

should take account of financially material ESG-related risks and fulfil their obligations to beneficiaries through investment strategies and stewardship activities. This move beyond 'comply and explain' to requiring statements of investment principles (SIPs) to be published and default strategies to become ESG-integrated and produce and publish and implementation report will turn the SIP into a meaningful tool for communicating long-term ESG-related and stewardship objectives and raising standards in the industry.

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?

Yes we agree that the proposals are proportionate and reasonable and support them – including the language used, which help clarify what is meant by 'sustainability', and include the explicit focus on climate change risks.

We believe the proposals as set out will create a clear and appropriate framework from which trustees can assess and then state their policy in relation to financially material ESG considerations. In due course it may be worth considering, as different reporting styles emerge, whether some kind of standardisation would be useful. But for now we believe the draft regulations meet the policy intent.

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?

Yes we agree with these proposals. Growing numbers of investors, especially but not limited to millennials[2], believe that their investment decisions can make a positive impact and want them used as a force for good. Creating an active requirement for trustees to assess and take account of scheme members views is therefore very welcome – and a key next step to ensuring appropriately fulfil their obligations to beneficiaries by taking these preferences into account. Further, by having a formal approach to canvassing scheme members' views, it is more likely that a cross-section of views will be heard rather than simply the most actively vocal 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?

We agree that at this time, as there is a lack of consensus on how to define and measure social impact, there should not be a requirement for trustees to state a policy in relation to

[2] See https://www.morganstanley.com/ideas/sustainable-socially-responsible-investing-millennials-drive-growth

social impact investment. However with a growing interest on the role the investment industry can play in delivering positive social but also environmental impact, this is an area that merits further consideration in future and trustees should be encouraged to voluntarily state their scheme's views on social impact. For now, however, we have no changes in legislation to propose.

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?

At Hermes we strongly believe that active stewardship - in the form of engaging, monitoring and voting – are key to long-term additional value creation and thus is an important means to achieving positive environmental and social impacts that go beyond short term financial returns, something we refer to at Hermes as 'holistic returns'. As a result, across our strategies we endeavour to act as a responsible steward of investments through constructive dialogue, utilisation of our rights as investors and taking action where necessary.

As such we agree with and fully endorse the proposal to amend the Investment Regulation to require the SIP includes the trustees policy in relation to voting, engagement and monitoring. This will serve to highlight and remind investors on an enduring basis of the importance of stewardship as a key means to improve investment performance and ESG outcomes over the long-term.

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?

Yes we do agree with the proposal – it is by requiring trustees to report on implementation that the transparency and accountability needed to deliver impact can be achieved. For example the proposals to require a policy in relation to stewardship of investments is important – but has a better chance of achieving the policy impact desired if there are also additional requirements to report on the outcome of those engagement activities. In this way more 'tick box' exercises can be avoided.

The draft regulations are likely to meet the policy intent. Including an expectation that SMART (specific, measurable, accurate, relevant and timely) metrics are used would provide further comfort on this.

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 agree with the proposals that the SIP, the implementation report and statement setting out how members' views are taken into account should be published online. This should reduce costs by avoiding the need to attend to every request for information. Easing access to this information should also foster further interest and engagement by members with respect to how their funds are invested. Finally it should ensure trustees are held to account while raising standards. Enabling the comparison to be made between different publicly available statements will, we hope, discourage the use of 'boiler plate' language and drive a race to the top in terms of improved policies and reporting and, of course, positive impact. As such yes we believe the draft regulations meet 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?

As a pensions investor we believe our primary purpose is helping beneficiaries retire better by providing world class active investment management and stewardship services. We believe this purpose includes a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial and consider the impact our decisions have on society, the environment and the wider world. It is this understanding that informs our belief that we have a duty to consider the longer term risks and opportunities when investing. This means extra work in analysing companies; understanding externalities; governance practices; environmental impacts; treatment of workforces; and the influence of operations on local communities. It also means using our influence to improve the behaviour of those companies in which we have invested; the operations of the assets that we directly manage; and advocating for systematic improvements to the financial system in which we participate.

Achieving this mission means putting the interests of our clients and their ultimate beneficiaries' front and centre of all that what we do. This is a commitment that all Hermes employees are signed up to and is embodied in our Pledge of Responsibility.

We believe the cost of doing this is outweighed by the benefits and as such wholeheartedly support this initiative from Government, which will act to mainstream such practices – quite rightly - across the industry. For example:

- In the research study – '*From the stockholder to the stakeholder*' - it was found that 80% of academic studies show that stock price performance of companies is positively influenced by good sustainability practices. The study concludes, based on the economic impact alone, it is in the best interest of investors and corporate managers to incorporate sustainability considerations into their decision making processes. [Source https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2508281]

- A second study – '*Carbon Disclosure, Emission Levels, and the Cost of Debt*' **-** demonstrates the link between carbon emissions and the cost of debt of companies. It found companies that are transparent regarding their CO_2 emissions have significantly lower cost of debt – again such companies would be picked up in ESG-aligned strategies. [Source https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2719665]

- A third paper by Hermes – *'ESG Investing: It still makes you feel good, it still makes you money*' – sets out how exposure to stocks with high ESG risk detracts from financial performance. Hermes analysis from 2014 found a strong correlation between corporate responsibility and shareholder returns, finding that companies with poor governance practices consistently underperformed their peers by up to 30bps each month. An update of this study in 2016 found this 'governance premium' is now entrenched: companies with strong corporate oversight have tended to outperform their poorly governed competitors by 30bps per month on average since the beginning of 2009. Furthermore, this study also shows that the premium holds true across different geographies and sectors – albeit with a few caveats – proving the widespread power of effective corporate governance. [https://www.hermes-investment.com/ukw/blog/perspective/esg-investing-still-makes-feel-good-still-makes-money/]

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

We have no other comments except to reiterate we fully support this initiative, which we expect will finally end the debate on ESG integration and fiduciary duty and will set the UK up as a global leader on this issue.

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?

Greater clarity – in the form of guidelines on how to take account of members' views, such as on social impact, would be useful. As noted earlier the approach the consultations take, the framing of questions and level of interest and expertise of members will all have a bearing on the outcome of such an exercise and so could lead to perverse outcomes. Guidelines on best practice in undertaking such member consultations – and what level of obligation the pension fund has to take these matters into consideration (for examples around materiality and appropriateness tests) would help manage the risk of perverse outcomes from his process.

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?

No comment

Yours sincerely,

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