Pension Trustees: Clarifying and Strengthening Investment Duties

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SUMMARY

Grant Thornton UK LLP is part of one of the world's leading organisations of independent advisory, tax and audit firms. We help dynamic organisations unlock their potential for growth by providing meaningful, forward-looking, advice. We are also a significant auditor of UK pension schemes.

Grant Thornton UK has a vision of a Vibrant Economy and has brought together communities and leaders from across the UK to shape this. We found that people from different sectors and places, of all political persuasions, have a common vision of an inclusive economy – one that is collaborative, open, trusted, connected and prosperous – where markets, businesses and places rediscover their purpose. We also found that people want to work together across traditional boundaries to achieve this.

One of the key enablers of this vision is instilling a clear wider purpose into financial markets to restore trust. We must move to a state where the majority of businesses account for social and environmental outcomes, as well as profits. Savers should be able to decide what societal or environmental outcomes they want their savings to achieve in addition to providing a financial return.

A supportive policy and regulatory framework will be required to accelerate the move towards purposeful finance. For example, listed businesses should report, in a comparable and verifiable way, on financial, social and environmental performance. Investment solutions, which facilitate investment in businesses with purpose, require further development.

We therefore welcome Government's response to the Law Commission recommendations and the consultation.

We believe it is timely that climate change is identified as a material financial risk, as a number of capital market participants have done. A failure to mitigate climate change will make it harder to achieve almost all of the other Sustainable Development Goals[1].

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[1] World Economic Forum, Global Risks Interconnection Map 2018
http://reports.weforum.org/global-risks-2018/global-risks-landscape-2018/#risks

Q1. We propose that the draft Regulation 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 with the proposals. The proposals meet the desire to accelerate the pace of change in the UK Trust-based pension market and address trustee confusion around these issues.

The proposals do not ensure that the goals of the financial system align with Sustainable Development Goals (SDGs). However, they are an important step in requiring trustees to think more broadly.

There are significant developments in the area of Responsible Investment, including the development of investment solutions aligned to the SDGs and climate action in particular. However, given the busy trustee schedule, the variable level of understanding around climate risk and other factors such as the narrow interpretation of fiduciary duty, these developments have not yet been recognised or acted upon by many schemes, hence the need for legislative action.

This is exacerbated by the conflation of terms such as ethical, sustainable, green, responsible and Environment, Social and Governance (ESG) among some Trustees and fund managers. Some interpret all such terms as meaning an investment strategy that excludes certain profitable stocks and is therefore incompatible with fiduciary duty. There is, though, increasing evidence that incorporating ESG into investment strategies can lead to higher and more sustainable returns[2]. There are also an ever increasing range of investment strategies available in the market which offer access for schemes in a variety of ways.

Given the challenges society faces, with the SDGs and climate change in particular, we support the Government's ambition whilst recognising this will be challenging for schemes that are not well-resourced.

We also recognise that climate change and other ESG risks are one of a basket of many risk and opportunities that schemes need to consider. However, from anecdotal evidence from Chief Investment Officers who have analysed these risks and made changes to their investment strategies,

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[2] There is a growing body of evidence that shows positive correlation between investment returns and incorporation of Environmental, Social and Governance ('ESG') factors. For example:

- **ESG & Corporate Financial Performance.** A comprehensive recent study of over 90% of 2,200 sampled studies dating from the 1970s, which found there to be a positive relationship between ESG performance and financial return.
  Friede, G., et al. (2015), ESG & Corporate Financial Performance: Mapping the global landscape, at:
  https://institutional.deutscheam.com/content/_media/K15090_Academic_Insights_UK_EMEA_RZ_Online_151201_Final_(2).pdf
- A recent MSCI study:
  https://www.msci.com/www/blog-posts/can-esg-add-alpha-/0182820893
- A paper from the Boston Consulting Group suggesting strong ESG traits in companies will lead to outperformance (and reference 13 contains links to further academic studies):
  https://www.bcg.com/publications/2017/total-societal-impact-new-lens-strategy.aspx
- A recent study from Stanford, following nearly 75,000 US companies over a 10 year period from 2005 to 2015, shows that low carbon companies also perform better than their high carbon counterparts
  https://gpc.stanford.edu/publications/being-green-rewarded-market-empirical-investigation-decarbonization-risk-and-stock

it is clear that they consider not only the downside risk but also the upside investment opportunity and this may be a point worth referencing.

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 ESG considerations, including climate change.

a) **Do you agree with the policy proposal?**
b) **Do the draft Regulations meet the policy intent?**

Yes, we agree with the proposal. The act of documenting a SIP should encourage trustees and their advisors to carefully consider these issues, which may arise over a longer time frame than is typically considered. For example, before documenting a position on climate change, trustees will need to understand the risk, assess how it impacts their scheme and decide what action may be appropriate[3].

For smaller or less well-resourced schemes, there is no definition of financially material given and it may be helpful for the Pensions Regulator or another body to provide guidance in this and other areas.

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 the proposal. There is low awareness and engagement among members on the ways in which their pensions are invested in the wider economy. We believe there is a real opportunity to improve the member engagement of Defined Contribution (DC) schemes by accompanying the pension statement with examples of the positive impact of their investments. For example:

- *Quietroom – Pension Money: where it's invested and the good it does*
- *Aviva – Do you know how your pension is invested?*
- *Shareaction – Pensions for the Next Generation*

Customer research finds an expectation from some pension savers that their pensions will be invested responsibly[4].

We see a real opportunity here to utilise digital technology to fundamentally change the customer engagement paradigm, both educating and empowering customers, allowing them to feel good about their pension, rather than confused or indifferent.

However, there are salient differences between DC and Defined Benefit (DB) schemes in this area. In particular, DB schemes may use complex and/or liability-driven investment strategies designed to match pension payments, which may contain significant derivative usage. For these schemes, there may be restrictions around the investment strategy meaning it may be practically challenging to reflect or incorporate member views, due to the two-stage test outlined in the consultation.

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[3] *https://www.grantthornton.co.uk/insights/climate-change--time-to-take-action/*

[4] Defined Contribution Investment Forum, Navigating ESG, April 2018. https://www.dcif.co.uk/wp-content/uploads/2018/04/navigating-esg-final-lo-res.pdf

We can also see challenges with incorporating member views which are based on ethical preferences. Some care will be needed in assessing members' views and the communication of how these are taken into account.

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?

All investments have impact, we simply don't measure many of them currently. For historical and structural reasons, the financial services industry has focused on short term financial outcomes. This need for change drives our thinking around Purposeful Finance.

Social impact investments are investments that fund a defined societal outcome, such as affordable housing and there may be different risk/return characteristics for these investments. However investors should consider risk, return ***and*** *impact across all their investments.*

We agree that Government should not compel trustees to pursue social impact investment. We believe financial services, including Trustees, must understand, measure and report on the impact of their portfolios more broadly, perhaps with reference to the Sustainable Development Goals, in addition to the current focus on financial risk and return.

We believe there is an urgent need to support those charged with governance around the importance of the impact of their investments. That is why we are involved with and supporting a number of initiatives aimed at addressing this issue, including:

- *The Future-Fit Business Benchmark: A robust framework for businesses to assess their operations against the SDGs.*
- *The World Benchmarking Alliance: Consistent and comparable corporate information on performance against the SDGs.*
- *The National Advisory Board for Impact Investing*

We also note the significant utilisation of passive investment strategies by pension schemes and therefore believe that active and appropriate stewardship and engagement will continue to be an important theme in driving good corporate outcomes.

Overall, with greater transparency and reporting on impact, we anticipate more trustees would choose to invest with impact.

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?

Yes, we agree with this policy proposal. As stated in our response to question 4, stewardship and engagement can be very effective in driving corporate change and we believe pension schemes, as responsible owners of companies, should have a clear policy on stewardship, which their investment managers should enact for them.

Q6. When trustees of relevant schemes produce their annual report, we propose 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 agree with this policy proposal. It is one thing to write down a policy, another to report on its implementation. We believe the publication of an implementation report, signed by the Chair of Trustees, is an important step. We note potential resource challenges for small and medium schemes and again, wonder if some kind of standardised format may be practically helpful.

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?

Yes, we agree with this policy proposal. Acknowledging the strain on resources of schemes we nonetheless cannot see much downside here.

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?

No comments at this time

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

Risks of a changing climate are inadequately integrated into most calculations of investment risk. As you referenced in the consultation document, Grant Thornton recently interviewed senior financial services professionals on this topic. Few had a basic awareness of the topic and fewer still understood the risks and opportunities for financial markets.

Savings and credit portfolios should be aligned with the purpose of "keeping a global temperature rise this century well below 2 degrees Celsius above pre-industrial levels" in line with the Government's commitment to the Paris Agreement.

Financial services companies, including pension schemes, should undertake appropriate analysis and reporting to evidence progress towards mitigating a material risk – in line with recommendations of the financial stability board taskforce on climate-related financial disclosures (TCFD). This analysis can then inform appropriate stewardship and engagement activities – we should be responsible owners.

At this moment in time, direction is arguably more important than position. Divesting completely from a company that is carbon heavy today (such as a coal powered utility which is in the process of transforming to renewables) could remove capital from a company which is supporting the energy transition.

A more nuanced approach would reduce exposure to companies exposed to transition risk and engage closely with carbon intensive firms to minimise emissions. For example, some commentators *have proposed encouraging tar sands companies to return cash to shareholders or invest in renewables, rather than expending capital on new carbon heavy extractive projects could be more effective than divesting. If all the responsible owners divest, who is left to engage with these companies?*

Nonetheless, we respect the decisions of certain individuals and institutions to divest from certain companies, with regard to climate change and can see a powerful case for this with the most egregious corporates who fail to recognise the urgent need to support climate action.

Q10. Do you agree that the 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, subject to the complexities highlighted in question 3 around member views.

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 further comment.