Pension trustees: clarifying and strengthening investment duties

Consultation response from Smart Pension

July 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?

Although we broadly agree with the proposals, we believe the timescales could be accelerated.

Current regulations require trustees to have a statement of investment principles (SIP) that details policies in relation to risk. As such, trustees should already be operating under a SIP, they meet regularly where the SIP is referred to and it can be reviewed. We therefore view the proposal as an amendment to the existing SIP, rather than a requirement to draft a new SIP from no existing base.

We propose to require the SIP to be published and included in annual benefit statements by April 2019 and for it to include how trustees take account of financially material considerations (including for the default strategy).

By October 2019, we propose that the SIP is updated to include policies relating to stewardship and the 'statement on member's views'.

We agree with the October 2020 deadline of requiring trustees of relevant schemes to produce an implementation report which is then published. This timeline allows schemes to incorporate member views which will have been collected.

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

In principle, we agree that the draft Regulations meet the policy intent. However, our specific comments and concerns are noted in subsequent questions.

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?

We welcome the removal of reference to "ethical considerations" in regulation 2(3)(b)(vii) since this implied a moral standpoint as opposed to a financial one in our view.

We also agree with the proposal to not exclusively refer to ESG and to state a policy on "financially material considerations" which include (but is not limited to) ESG including climate change. As the consultation notes, ESG is widely used and understood and there is a long-standing use of ESG terminology so there is no specific need to be too prescriptive. Furthermore, while we approve of the recognition that climate change should be extracted since it is a systemic and cross-cutting risk, we would also like to see future legislation adapt to the changing global environment. Climate change is undoubtably the most real and present risk to future worldwide stability, but new and urgent ESG risks are likely to emerge, and legislation should be flexible enough to address this.

Although we are encouraged by the proposals, we do see an opportunity to clarify the wording regarding "financially material considerations" in regulation 2(3)(b)(vi). We propose to insert the further clarification of: "financially material considerations **(risks and/or opportunities)**, including how those considerations are taken into account in the selection, retention and realisation of investments".

We believe the reason for this is twofold.

Firstly, as the consultation itself notes, 2(3)(b)(vi) could be perceived as overlapping with existing considerations of risks referred to in regulation 2(3)(b)(iii).

Secondly, the Law Commission recommended that legislation should state a policy in relation to the evaluation of financially material risks as well as opportunities. ESG in particular is being viewed more frequently through both a risk and opportunity lens and the regulations should reflect it as such.

b) Do the draft Regulations meet the policy intent?

We would like to see regulation 2(3)(b)(vi) further clarified to consider both risks and opportunities as financially material considerations.

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?

In our view, the policy could be further clarified:

- While the Law Commission has stated that there is not a threshold response rate which must be met for trustees to decide whether to act on the results of a member survey, we would welcome broad threshold ranges that could serve as benchmarks. As an AE provider, most of our active members display inertia. We can envisage a scenario where a particular demographic responds to a survey, but the majority of members do not respond at all. It would be helpful to know above which proportion of membership responses should trustees consider.
- Although ESG is considered a widely used term and generally understood, this may not be the case for all active members of pension schemes. We would welcome clarity on how "ESG" should be framed for member surveys and any standardisation of acceptable terms (for example, ensuring the exclusion of "ethics" when discussing ESG). This will avoid leading questions in surveys and ensure consistency of terminology across schemes which will benefit members.
- We would welcome some guidance regarding a situation where trustees believe a non-financial matter is held by members, is thus taken into account and acted on, but which then becomes financially material and detrimental to returns. We believe this situation should be communicated to members, however it could result in confusion and lack of transparency for members.
- Regulation 4(3) notes that "the powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole." Given this, we see a need to clarify the situation where trustees believe members hold a particular view and there is no risk to financial detriment, but the

appropriate investment to take account of this view is relatively illiquid. The same could be true if this investment is outside of the charge cap. We would welcome some legislation or guidance on trustee options in such scenarios.

b) Do the draft Regulations meet the policy intent?

We believe the wording in the draft Regulations can be further explained. There is mention of "financially material considerations" which trustees must consider, and "non-financial matters" which trustees can take into account. It would be beneficial to be explicit whether non-financial matters are equivalent to a "non-financially material consideration". Whether something is financially material or not can be construed and understood as something different to a non-financial matter.

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?

By virtue of their size in the market, pension funds have high potential to bring about positive social impact. There is therefore an opportunity to utilise these investment funds to drive social good. Additionally, as younger pension savers (who are typically more engaged in this type of investing) start their retirement savings journey, it is likely that they may start to demand social impact investing as part of their savings. There is also an opportunity cost of delaying inclusion of social impact investing in the proposals since many younger savers are already engaging with this type of saving through crowdfunding and micro-loans.

Furthermore, we do not perceive a situation where scheme members would disagree with their pension savings being used to create positive social outcomes. The Defined Contribution Investment Forum research provides some evidence of this.

We therefore propose that trustees should have a policy regarding social impact investing and that regulation should adopt the aims of the Advisory Group on Social Impact Investment detailed in the consultation (paragraph 47, page 23). However, we also believe that regulation should include the following:

- "Social impact investment" should be defined for the purpose of regulation in order to avoid trustee confusion. We propose adoption of the Advisory Group's definition.
- Clarification and amendment of the Law Commission's 2-stage test which notes that there should be "no risk of significant financial detriment to the fund". This in and of itself is hard to achieve since the very nature of risk involves uncertainty; elements of any investment could potentially result in significant financial detriment. We therefore propose the amendment of the second test of the 2-stage test to read "no significant risk of financial detriment to the fund". This will allow for social impact investing to be considered through the lens of risk management and not solely through financial return and results in a balanced view.
- As noted above, Regulation 4(3) notes that "the powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole." Regulation would need to be amended to include the situation where social impact investing results in a sacrifice to liquidity. While we do not advocate having prescriptive regulation, it would be beneficial to have liquidity thresholds which could guide whether a social impact investment could be included at the cost of liquidity.

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?

We do agree with the policy proposal although in our view trustees should be engaging with companies alongside investment managers as opposed to effectively outsourcing their stewardship activities to their investment managers. Trustee stewardship policies should also be constantly reviewed and referred to so that they do not become a "box-ticking" exercise.

b. Do the draft Regulations meet the policy intent?

We propose that in regulation 3(c)(ii) the word "continually" is inserted to read: "undertaking engagement activities in respect of the investments (including the methods by which and the circumstances under which trustees would **continually** monitor and engage with relevant persons

and other persons about relevant matters)". This is because engagement is not a once off activity but rather should be carried out continually in order to fully manage risks and opportunities.

As an AE provider, we also advocate the inclusion in these regulations regarding tPR guidance to DC trustees in respect of pooled funds. We therefore encourage the inclusion of "trustees becoming familiar with [investment] managers' stewardship policies and where considered appropriate, seek to influence them".

In the longer term, we believe there is also scope to include policy on stewardship voting criteria, as detailed in tPR guidance. There would need to be consistency of methodology here, but once this is detailed it would be good for members to be able to transparently see how voting and engagement has been carried out.

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?

We believe that by making the SIP publicly available, best-in-class will be visible and transparent to members.

b) Do the draft Regulations meet the policy intent?

We consider that the draft Regulations meet the policy intent. We also see an opportunity to be more prescriptive around the location and prose of the SIP, annual report, implementation report and report on member views. All publicly available reports should be stored in an obvious and easy to access webpage (or similar), should be easy for members to read and understand, and should take account of potential member disabilities e.g. available in braille.

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?

We agree with the policy proposals although as noted above, we believe that some timescales can be accelerated.

b) Do the draft Regulations meet the policy intent?

Subject to our views already detailed in this submission, 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?

No further comments.

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

No further comments.

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?

Yes, although we believe the timescales of the draft regulations detailed above could be accelerated.

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?

We see that there is an opportunity to enhance the trustee investment approach through the requirement for trustees to have both a SIP and a SIA (Summary of Investment Arrangements). This allows for the SIP to be more digestible to members and for the SIA to detail low level investment strategies to be followed by trustees. We see the SIP as being a publicly available document but the SIA being a trustee-only document.