RESPONSE TO THE DEPARTMENT FOR WORK AND PENSIONS CONSULTATION ON PENSION TRUSTEES' INVESTMENT DUTIES

16 July 2018

INTRODUCTION

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has over 2000 signatories (pension funds, insurers, investment managers and service providers) globally with approximately US $70 trillion in assets under management.

Over 250 PRI signatories are based in the UK, 50 of which are asset owners.[1] They manage assets worth approximately GBP £927 billion, primarily in non-corporate and corporate defined (DB) benefit and defined contribution (DC) pension funds.

Responsible investment explicitly acknowledges the relevance to investors of environmental, social and governance (ESG) factors in investment decision-making for the long-term health and stability of financial markets.

The PRI welcomes the opportunity to contribute evidence to the Department for Work and Pensions (DWP) consultation on the policy proposals and to the revisions to the draft Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2018.

ABOUT THE CONSULTATION

In June 2018 the DWP launched a public consultation to seek views on policy proposals and draft Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2018.

These proposed regulations would amend the required content of the Statement of Investment Principles (SIP) and the steps which trustees need to take when revising it, or preparing it for the first time. They would also require some trustees to publish the SIP as well as an annual report on how they implemented it, and to tell members of its availability via the annual benefit statement.

[1] See https://www.unpri.org/signatory-directory/

SUMMARY OF THE PRI'S POSITION

The PRI strongly endorses the proposed amendment to the Investment Regulations to clarify that the consideration of ESG factors is a core part of prudent investment decision-making.

The amended Investment Regulations must:

- reflect the modern interpretation of fiduciary duty in relation to ESG factors;
- dispel any remaining confusion between financially material ESG factors and ethical issues;
- and remove wording that creates a misleading impression of optionality around the incorporation of ESG considerations into investment processes.

The Law Commission proposed clarification of fiduciary duty in 2014 and in 2017. It Is also a key recommendation of the PRI and UNEP FI's Fiduciary Duty in the 21st Century UK Roadmap, delivered in 2016, following consultation and interviews with over 30 stakeholders from the investment industry, regulators and government.

CONSULTATION QUESTION RESPONSES

Evaluating financially material risks and opportunities, including ESG and climate change

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?

PRI strongly agrees with this proposal.

Principle 1 of the Principles for Responsible Investment states that signatories to the PRI "will incorporate ESG issues into investment analysis and decision-making processes." This policy proposal is aligned with the intentions of over 2000 signatories to the PRI which indicates widespread support for the integration of ESG factors in investment decision-making.[2]

The PRI believes that ESG issues, including climate change, can influence investment risk and return. Trustees have a fiduciary duty to invest in beneficiaries' best financial interests, and must therefore consider all relevant issues in order to fulfil that duty, including ESG issues. Despite this, integration of ESG issues into investment decision-making by investors remains partial or absent from the practices of many investors in the UK. The following studies provide evidence:

- Mercer surveyed over 1200 European pension funds in 2017 and found that only around 20% of European pension funds integrate ESG factors into investment policy, through a range of approaches. The report also notes a sharp increase in the number of funds integrating ESG due to financial materiality of ESG risk, and that 5% of European pension funds have considered climate risk.

[2] The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system. By becoming signatories to the PRI, investors publicly commit to adopt and implement the six Principles. They can be seen here.

- The FCA Asset Management Market Study interim report refers to an Investment Association (IA) study, stating that "in a recent sample of 34 IA members, half reported that they managed at least some proportion of assets according to ESG considerations and, where they did, approximately one fifth of total assets were subject to ESG requirements."
- ShareAction conducted an in depth study of 40 European asset managers and found wide variation between leaders and laggards on ESG factors. This report also concluded legal clarity around ESG was necessary.

Therefore, we agree with the DWP that regulation is required to drive standards for the systematic consideration of ESG issues in investment decision-making by UK pension funds and therefore close this gap in implementation.

The proposal to require trustees to produce a SIP to state their policy in relation to ESG factors will offer greater clarity that trustees must take these issues into account. We believe this will help to end any remaining confusion with regards to fiduciary duty and financially relevant ESG issues.

We welcome clarity provided by the DWP in its consultation document that the draft regulations would amend the requirements of the SIP (as applicable to schemes with over 100 members) and also the default strategy.

We welcome emphasis in the DWP consultation that trustees are rightfully required to form their own conclusions about the materiality of risks, taking into account the advice they receive from their consultants.

We make three recommendations:

1. The Pensions Regulator (TPR) should review guidance on knowledge and understanding required by trustees

Section 247 and 248 of the Pensions Act 2014 requires trustees to have relevant knowledge and understanding to exercise their role. Trustees have a legal requirement to explain in the annual chair's statement how they meet the requirements for having appropriate knowledge and understanding, and how the trustee's combined knowledge and understandings (and the advice available to them) enable them to properly exercise their trustee functions. This is supported by TPR's Trustee Knowledge and Understanding (TKU) Code of Practice and its accompanying guidance.

We recommend that the supporting guidance on trustees knowledge and understanding is reviewed and updated if necessary to best support trustees ability to meet their obligation under the Pensions Act and proposed amendments to the Investment Regulations.[3]

2. The DWP should work with the Financial Conduct Authority (FCA) to ensure that investment consultants integrate ESG issues into their services

The FCA's Asset Management Market Study raised concerns that investors struggle to assess whether they were receiving value for money from their consultants. The report recommended that investment consultants be brought into the regulatory perimeter, subject to the outcome of a provisional market investigation by the Competition Markets Authority. It did not fully examine the provision advice pertaining to ESG factors specifically as part of the advice clients receive.

The PRI's Investment Consultant Services Review notes that most trustees meet the regulated requirement to "obtain and consider proper advice" on whether an investment is "satisfactory" by appointing an investment consultant. However, as noted above, the content of the advice is not currently regulated, and the provision of advice that takes ESG issues into account is lacking.

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[3] In 2016, the TPR held a consultation on 21st century trusteeship code of practice and governance, with the paper presenting at least four potential options following feedback from the consultation to raise trusteeship standards. The TPR may be minded to act on trustee board competency.

We recommend that the DWP engages with the FCA identify solutions to ensure that investment consultants integrate ESG issues into their services to best support trustees ability to meet their obligation under the Pensions Act and proposed amendments to the Investment Regulations.

3. The DWP should work with the FCA to extend similar regulatory provisions for contract based schemes

We believe that pension beneficiaries should receive the same quality of investment decision-making - including the consideration of ESG issues - by those investing in their behalf, regardless of whether their pension is a contract or trust based fund.

It is the role of the FCA to ensure that firms that provide contract based schemes treat their customers fairly. Similarly, TPR requires that trustees act in the best interests of their scheme beneficiaries.

Given the differences between the regulatory regimes overseeing these schemes (by the FCA and TPR respectively) we recommend that DWP actively work with the FCA to extend similar regulatory provisions for contract based schemes**,** ensure consistency and clarity in their regulatory approach and minimum standards on ESG integration for pension products across both contract and trust based funds.

b) Do the draft regulations meet the policy intent?

The PRI believes that the draft regulation text is clear and meets the policy intent.

We support removal of the word “ethical” to make clear that financially material ESG issues and ethical factors are distinct considerations, and that trustees’ primary fiduciary duty is on investment returns.

We strongly support removal of the phrase “if at all” to make clear that trustees must take account of all factors that are financially relevant, including ESG issues. This is consistent with the recommendation made in PRI and UNEPFI’s Fiduciary Duty UK roadmap which also identified this clause as misleading.

We support specific reference to climate change. Climate change needs to be considered at all stages of the investment process: trustees need to consider it in their investment strategy in addition to engagement with their asset managers about how they are considering climate change issues in investment decision-making on behalf of the fund and its beneficiaries. This is because climate change issues pose portfolio and systemic risk to financial markets.

We agree with the proposed wording of “environmental, social and governance” rather than using the abbreviated, ‘ESG.’

We recommend that the term “non-financial” is removed from the proposed amendment clause of the regulation paragraph 2, sub paragraph (c) “(including the views they hold on non-financial matters)” to avoid confusion in interpretation of which issues within the definition provided may be considered “non-financial” and “not financially material.”

We recommend the regulation stipulates that trustees are required to take into account financially material factors as consistent with time horizon of the investment liabilities of the scheme and its members.

We believe that it is important for pension funds within the UK market and PRI’s membership that integrate ethical considerations into their investment decision-making continue to do so.

Taking account of members' views and broader interests

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?

The PRI agrees with this proposal.

We support a requirement for trustees of funds with over 100 members in DB and DC funds to prepare a statement explaining the extent to which trustees will take beneficiaries views into account.[4] We believe in the principle that it is the role of trustees to seek to understand beneficiaries' investment preferences in their capacity as stewards of the capital belonging to future retirees.

We believe that a requirement to set out how trustees take account of members' views will ensure that:

i) trustees' primary focus is their requirement to deliver in the best interests of their beneficiaries over the time horizon of the investment liability;

discretion to implement member preferences in investment strategy remains with trustees;

ii) trustees have discretion on the extent and method of the engagement with beneficiaries as appropriate for their fund size and structure.

b) Do the draft regulations meet the policy intent?

Yes, however we recommend the regulator issue guidance on gathering members' views, to clarify, among other issues:

- suggested methods of gathering members views that trustees could use and disclose to demonstrate that they have adequately sought member views;[5]
- examples of best practice engagement (including internationally);
- examples of disclosure to demonstrate why trustees have chosen not to incorporate member preferences into investment strategy;
- executing the two-stage test for incorporating preferences into investment strategy.[6]

Further we recommend that the DWP emphasise trustee discretion in its communication of this proposed amendment to minimise confusion among trustees.

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[4] We note that savers bear the investment risk in DC pensions and therefore may have greater interest and engagement about how their money is invested.

[5] We believe that there is need for further clarity to provide non-prescriptive examples of processes trustees could use to gather member views. The consultation paper notes that trustees do not need to survey members, and that methods should be "appropriate and proportionate" but it does not elaborate on the role of member nominated trustees in this regard, nor other suggested methods to engage beneficiaries in an impartial manner.

[6] For example, guidance on: how this is practically applied in different types of schemes (DB, DC and master trusts); considering divergent views from members; interpreting what may be considered 'significant' financial detriment; how to manage incorporating preferences into investment strategy with regard charge cap deadlines.

Social impact investment

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. The UK must achieve minimum standards and clarity on the consideration of ESG issues in investment decision-making as a priority.

We believe that creating a regulatory requirement for trustees to state their policy in relation to social impact investment concurrently with other amendments to the Investment Regulations may conflate these issues.

We encourage the DWP to review regulation with regard trustees' policy in relation to social impact investing at a future time.

Stewardship of investments

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?

The PRI welcomes the requirement to disclose the process on stewardship.

Principle 2 of the Principles for Responsible Investment states that signatories to the PRI "will be active owners and incorporate ESG issues into our ownership policies and practices." This policy proposal is aligned with the intentions of over 2000 signatories to the PRI which indicates widespread support for stewardship of investments.[7]

We welcome the broader the definition of stewardship to include voting, engaging and monitoring[8] which aligns with the PRI's view of stewardship.[9]

The PRI's guide to active ownership in listed equity asserts that stewardship is one of the most effective means to minimise risks and maximise returns to enhance and protect the value of pension investments.[10] It also provides examples of how collaboration between investors enables pension funds (and particularly those that are small and resource constrained) to engage asset manager to ensure that they have good stewardship practices and to engage companies directly.

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[7] See the six Principles for Responsible Investment here.

[8] Noting that it is already a regulated requirement for defined contribution (DC) schemes to disclose on fund voting policy.

[9] The guide includes findings from interviews with over 40 global institutional investors about how they use stewardship to protect and enhance the value of their listed equity investments. Asset owners outsourcing activities, partially or entirely, can use this guidance to define their expectations, select third parties and monitor their activities.

[10] The report provides multiple studies that illustrate positive correlation between better financial returns and active ownership (page 14). In addition, a quantitative study "how ESG engagements creates value for investors and companies" provides clear evidence that engagement by investors with companies on ESG issues can create shareholder value. The study was led by the University of Cambridge and the London School of Economics on more than 30 PRI-coordinated collaborative engagements involving 225 institutional investors and 964 companies.

In addition, the PRI's publication on how asset owners can drive responsible investment asserts that asset owners' stewardship and engagement with their fiduciary managers have a large influence on stewardship of assets across the investment chain.

Therefore we believe that trustee stewardship is critical to investment returns and strongly agree the policy proposal.

We welcome alignment with the direction of the revised European Shareholder Rights Directive (2016)[11] which calls for asset owners to establish and publicly disclose an engagement and voting policy, and report on how they implement the policy on an annual basis (on a comply or explain basis).

Furthermore, a duty to require trustees to state their policy in relation to the stewardship of their investments reinforces the work of the UK Financial Reporting Council (FRC) and its forthcoming review of the UK Stewardship Code.[12]

Lastly, regarding the application of this requirement to schemes of over 100 members, we believe that pension beneficiaries should in principle receive the same quality of stewardship and ESG risk management processes within their investments by those investing in their behalf, regardless of size of fund. Therefore we recommend that this amendment to the Investment Regulations should be considered alongside UK pension fund pooling.

b) Do the draft regulations meet the policy intent?

We recommend that the DWP amend the draft regulations so that all the requirements of the SIP apply equally to the default scheme (including Regulation 2(3)(c)) and ensure that trustees of the default fund are required to publish their stewardship policy in their SIP.

Currently the draft regulations appear to require that the trustees' annual report has to include this policy (in the amendment to Schedule 3 paragraph 30d of the Disclosure Regulations) whereas the SIP does not have to (as there is no amendment to Regulation 2A(1)b of the Investment Regulations).

Given the importance of stewardship to minimise risk, maximise returns, and for the good functioning of equity markets,[13] and given that that the majority of members are in the default arrangement, trustees of the default should also be required to include their policy on stewardship (subject to the 100 member threshold).

We recommend redrafting the definition of terms in 2. (4) to address the following issues:

- "non-financial matters" should state that such matters "*may* include (but is not limited to)…" to allow for the fact that some investments that have a positive social impact may be made on a financial basis;
- "relevant matters" should also include investee companies' "opportunities";

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[11] The directive refers to institutional investors defined as Institutions for Occupational Retirement Provision (IORPs) and those providing life assurance.

[12] An initial consultation on the future direction of the UK Stewardship Code was opened for comment between December 2017 and February 2018. The FRC announced that a formal consultation on the UK Stewardship Code will be launched later in 2018. The PRI's response to the initial consultation is that "the UK Stewardship Code should explicitly state that environmental and social issues are important drivers of long-term investment value, and are part of the fiduciary duty that investors owe to their clients and beneficiaries." The PRI's response be seen in full here.

[13] See the 2012 Kay review of UK equity markets and long-term decision making

- "relevant persons" should also include "investment consultants."

Reporting on implementation of SIP policies

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?

The PRI agrees with the policy proposal.

We believe that requiring trustees to produce a statement setting out changes made to the SIP, how it has been implemented, and how trustees have accounted for members' views will require greater clarity and scrutiny from trustees on how they meet the regulations.

We recommend that the regulator consider providing short guidance on content, length and format of the implementation report.

b) Do the draft regulations meet the policy intent?

Yes.

Publication of SIP and implementation report

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?

The PRI agrees with the policy proposal.

We believe that pension fund members should have access to information about how their scheme is investing and managing risks and maximising opportunities on their behalf, and we believe that transparency will help to drive high standards of SIP and their implementation

b) Do the draft regulations meet the policy intent?

Yes.

We recommend that the DWP seek and consider feedback from trustees about how the draft regulations may more suitably reflect differences for DB and DC funds.

APPENDIX A

Full list of consultation questions:

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?

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?

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?

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?

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?

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?

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?

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?

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

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?

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?