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Subject: Pension trustees: clarifying and strengthening investment duties

Dear Ms Donnelly and Ms Bird

We welcome the opportunity to respond to the DWP consultation on *Pension trustees: clarifying and strengthening investment duties*.

Our detailed comments are attached in the appendix to this letter.

We would welcome the opportunity to discuss our response further with you if that would be helpful.

Yours sincerely

[by email]

Kate Brett

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APPENDIX

Question
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?** • In principal, Mercer is supportive of the timeframes set out. In our view, one year provides sufficient time for trustees to prepare for the new legislation and, should they be required to do so, to update the Statement of Investment Principles (SIP) documentation. However, we believe the regulations could be clearer about what is expected (see below). We believe that the two-year timeframe for the implementation report is appropriate as it enables the trustees to review any changes implemented as a result of any prior changes to the SIP. **b) Do you agree that the draft Regulations meet the policy intent?** • In principle we agree that they do, but we are uncertain about the exact requirements regarding timing. In particular, it seems to us that all SIPs will need to be updated to meet the requirements on financially material investments and stewardship by (i.e. before) 1 October 2019. They will then only have to include the statement on how they take into account member's views when the SIP is next prepared or updated after 1 October 2019, which in theory could be up to three years for schemes that aren't relevant schemes. However, the Regulations also appear to require relevant schemes to publish their SIP and statement on members' views from 1 October 2019, so for these schemes the statement will also be required from 1 October 2019. • It would be helpful if the Government could confirm its expected timeframe for each of the new requirements, for "relevant" schemes and for schemes that are not relevant.

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?

- Mercer supports the proposed policy. Mercer believes that ESG issues, including climate change, can have material financial impacts and should be considered alongside the other investment risks faced by pension schemes. However, even following the updated guidance from the Pensions Regulator (TPR) in 2016 (DC schemes) and 2017 (DB schemes) in our view, there continues to be some confusion amongst trustees as to how ESG issues should be taken into account. We support the proposal to make the wording in the existing Investment Regulations consistent with the guidance set out by TPR and believe this will introduce more clarity to trustees' obligations. Mercer is one of sixteen UK consultants that has publicly committed to raising the TPR guidance on ESG with pension scheme trustees. A consistent regulatory framework will improve the adoption of the TPR guidance by trustees. We appreciate the reservations expressed that various terms considered, including sustainability, long-term and corporate governance could be unclear, and support the proposed focus on financially material considerations.
- Mercer supports the explicit reference to climate change. Mercer has undertaken extensive research on the potential impacts of climate change on investor portfolios from a risk and return perspective[1]. This work has found that climate change is a systemic risk and that long-term investors should consider the potential impacts when setting and implementing their investment strategy, as well as when selecting investment managers and as part of ongoing portfolio monitoring and engagement with both investee companies and policy makers. Our most recent European Asset Allocation[2] survey found that while the number of pension funds across Europe considering climate change risk has increased significantly (from 5% in 2017 to 17% in 2018), there remains a large number of schemes not yet addressing the investment risks and opportunities posed by climate change. In our view, explicit reference within the guidance will clarify the importance of this risk to asset owners.
- We believe it would be helpful if updated guidance from TPR gives some indication of what would be proportionate for schemes of different sizes.

b) Do the draft Regulations meet the policy intent?

- Yes. The draft regulations establish clearly that ESG issues are one of many aspects trustees should take into account and further removes one of the existing barriers where ESG issues are still misunderstood as either being not financially material or purely an ethical concern.

[1] Investing in a Time of Climate Change, Mercer (2015) see: https://www.mercer.com/content/dam/mercer/attachments/global/investments/mercer-climate-change-report-2015.pdf

[2] European Asset Allocation Report

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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?

- While we broadly support the intent behind this proposal and support the inclusion of a statement alongside the SIP, we believe the proposal and expectations for trustees should be further clarified.
- There is evidence that members, particularly younger members of DC plans, increasingly expect their views to be taken into account in how their scheme is managed. It is reasonable to expect DC savers to take more interest than DB savers in how their contributions are invested, since their investment strategy will directly affect their benefit outcomes. We believe that taking member views into account offers DC schemes the opportunity to increase member engagement in pensions and savings more generally and are supportive of this.
- The position is slightly different for DB schemes, since the sponsoring employer largely bears the investment risk. We believe that it would be helpful for TPR to update its guidance to indicate how DB scheme trustees should approach taking members' views into account as well as those of the employer.
- While the consultation document highlights the comments from the Law Commission review as to how member engagement may be carried out in practice (e.g. holding workshops for members), the process will need to be proportionate. There is already misunderstanding that this change would require trustees to undertake annual surveys of its membership; while such exercises may play a useful role, they can be difficult to manage and costly.
- As such we believe clarification on the expectations of trustees and engagement methods should be provided, further clarifying (and strongly messaging) that trustees have ultimate discretion on how to invest.
- Trustees could also give consideration to whether member nominated trustees could provide a communication channel between the wider membership base and the trustee board.

b) Do the draft Regulations meet the policy intent?

- The 2-step test set out in the consultation document seems a sensible approach and should provide clarity to trustees. However as noted above, we believe there is already some misunderstanding about what is expected. Guidance could be used to clarify what the statement should cover and what would be viewed as appropriate given differences between schemes (e.g. DB vs. DC, large vs. small).

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?

- Mercer supports the approach taken towards social impact investment. Since the social impact investment market in the UK is still at an early stage, it should not be made an explicit requirement to state a policy at this stage, although trustees should be encouraged to include this when developing their investment strategy.
- Mercer was part of the advisory group that contributed to the document 'Creating a Culture of Social Impact Investing in the UK', and we believe that, as the market develops, social impacting investing could offer strong potential with respect to employee engagement, particularly for DC members. Where schemes have chosen to include or offer such solutions, given the focus on transparency and disclosure we would encourage them to include details of their approach to social impact investing within the SIP.
- Encouraging trustees to disclose a statement on social impact investment would help provide further support to the aims of the Advisory Group on Social Impact Investment.
- We support the intention to keep monitoring social impact investment, including trends in terminology and the availability and labelling of social impact investment products. Mercer is seeing increased interest in this area as well as an increasing number of institutional solutions. The proposed amendments to the investment regulations are quite broad and could, implicitly, encompass social impact investment as the market develops, but we agree that guidance and regulation in this area should be monitored.

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?

- Yes, we agree with this proposal. The effective stewardship of assets is an important aspect of any investment strategy and many schemes already include such information within their SIP.
- Effective stewardship of assets is important, including for those entities such as pension schemes where trustees are responsible for stewardship decisions on members' behalf. As such, we support the proposal that trustees explicitly state their policy and expectations on stewardship, which we view as an important aspect of any investment strategy, particularly where assets may be held on a passive index-tracking basis.
- However, it would be helpful if updated guidance from TPR gives some indication of what would be proportionate for schemes of different sizes, in particular smaller schemes, given there are usually constraints on their time and resources. For instance existing guidance encourages such schemes to become familiar with their managers' stewardship policies and where appropriate seek to influence them. However it also notes that for wholly insured schemes, it is unlikely to be possible to engage directly with the provider's fund managers, but trustees could ask the provider for information about the fund manager's stewardship policies.

b) Do the draft Regulations meet the policy intent?

- Yes.

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?

- Yes, we support this proposal. Many schemes already include such information within their annual reporting to members and formalising this would be beneficial to the industry. There is increasing expectation of transparency and disclosure across the investment chain, including from asset owners to scheme members.

b) Do the draft Regulations meet the policy intent?

- Overall yes but please note our earlier comments with respect to the statement outlining how trustees will take account of members' views in the annual 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?

- Yes, we support this proposal. As noted above, there is increasing expectation of transparency and disclosure across the investment chain. In addition, in our view, this would be helpful for increased member engagement, where there is increasing expectation that member information should be readily and easily accessible online.

b) Do the draft Regulations meet the policy intent?

- We would suggest that in Regulation 4(a), the insertion should be "and (2A)" rather than "or 2(A)"

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?

- We do not believe the changes proposed are overly burdensome to business, provided any associated guidance makes clear they can be implemented proportionately, taking into account the nature and size of the scheme, for example.
- In particular, clarity should be provided with respect to the proposals on engaging member views as this seems to have led to the misconception that this requires trustees undertaking a survey of member views. This would typically be a burdensome exercise (in terms of both cost and resource) and while it may be an option that some schemes choose to take, we believe clarification that trustees are expected to comment on how members' views have been taking into consideration would be helpful.

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?

- Yes, we agree that the revised Statutory Guidance provides clarity to trustees and the industry more broadly.

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?