Elias Koufou
DWP Consultation Coordinator
2nd Floor
Caxton House
Tothill St
London SW1H 9NA

Dear Mr Koufou,

Consultation on changes to the Investment Regulations following the Law Commission's report 'Fiduciary Duties of Investment Intermediaries'

I am pleased to respond to the consultation on changes to the Investment Regulations in my personal capacity. I am an independent responsible investment advisor, working principally with asset owners. I have worked with pension funds and other asset owners in Australia, Canada, the Netherlands, Norway, Sweden, the UK and the US. I am a past member of the Strategy Council to the Norwegian Government Pension Fund. I previously worked at the UN-supported Principles for Responsible Investment, London; APG Group, Amsterdam (the investment manager for Europe's largest pension fund, ABP); and Henderson Global Investors, London.

General remarks

The disclosures required by the Investment Regulations should be designed with the objective of the Kay Review and the Law Commission report in mind – i.e. to promote a long(er)-term approach to investment. Clarifying the nature of the matters to which trustees should have regard in this context, and the extent to which 'ESG' issues are relevant to this objective, is an important aim for the revised Regulations. However, this will not in itself guarantee changed behaviour by trustees. The new regulations should be designed to promote real changes in thinking, behaviour and investment decisions and should discourage compliance-orientated standardized disclosure – as has tended to occur in the past. The objective should be to trigger new kinds of discussion among trustees, and between trustees and the participants in the investment chain – most notably investment consultants and asset managers.

Consultation Question 1 – How could 2(3)(b) of the Investment Regulations be amended so that it more clearly reflects the distinction between financial and non-financial factors?

- *'Financial' vs. 'Non-financial'*

The objective of promoting long-term investment requires that trustees take account of a wide range of factors that will be relevant to their investment returns over varying timescales. Some issues will be relevant in both the short term and the longer term, though perhaps to different extents. Other matters may be relevant only over longer periods. Some 'ESG' issues may be relevant over short timescales, others only over longer horizons. Some 'ESG' issues may not be financially material even over very long timescales (though they may be of great importance to society at large). The Regulations should be worded in such a way as to recognise this complexity.

The Regulations should require trustees to explain:

- **how they identify issues that are relevant to their investment objectives, in the context of their DB liabilities and/or their DC ambitions, in both the short term and the long term, including relevant environmental, social and governance issues;**
- **how they reflect their view on these issues in their investment strategy; and**

- **how they keep their identification of relevant issues under regular review.**

Requiring an explanation of *how* issues are identified, rather than simply the disclosure of a policy, is more likely to lead to substantive changes in investment behaviour.

- *Investment beliefs*

As has been highlighted by the Focusing Capital on the Long Term Initiative[1], which involves some of the world's largest and most sophisticated pension funds, the development of well-founded investment beliefs that are specific to the investor's particular circumstances is an important foundation for long-term investment. Investment beliefs are 'assertions about investments and the way the investment world works which, when developed and shared, help with investment decision making'.[2] The process of developing this high-level framework to guide investment strategy and decisions enables – indeed requires - trustees to analyse how a range of factors might influence their investment returns over the timescales that are relevant to them. Relevant ESG factors should fall into place naturally within such a process.

The Regulations should require trustees to develop and disclose a set of investment beliefs. In order to encourage improved long-term investment decision-making and not simply compliance-orientated disclosure, the Regulations should also require an explanation of the process by which they have developed their investment beliefs, and to explain how they have ensured that all relevant long-term factors have been taken into account, including what research they have conducted and what advice they have sought.

Investment beliefs would sit at a higher level in the trustees' investment strategy process than the matters to be disclosed under the recommendation proposed in the preceding section. The disclosures suggested there would provide greater detail on a sub-set of the matters to be covered by investment beliefs (which often also address matters such as the fund's view on how markets work; active vs. passive management; internal vs. external asset management; the role of diversification, etc.).

To support trustees in meeting these requirements, I would further recommend that The Pension Regulator prepare guidance setting out the characteristics of an appropriate process for the development of investment beliefs.

- *Risk*

The way in which investment risk – rather than risks (plural) in the sense of 'issues' or 'factors' – is measured and managed is central to aim of promoting long-termism. As CalPERS, the largest pension fund in the US, puts it in its investment beliefs, 'Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error. … As a long-term investor, CalPERS must consider risk factors, for example climate change and natural resource availability, that emerge slowly over long time periods, but could have a material impact on company or portfolio returns.' [3] Defining and monitoring risk as volatility against a benchmark will discourage a focus on real underlying risks to returns over longer periods – including relevant 'ESG' issues.

The Regulations should require trustees to explain how they measure and manage risk over short and long timescales, taking into account the range of factors that can influence their returns.

- *Building trustee capabilities*

Experience in South Africa illustrates that legislation stipulating that ESG issues should be taken into account as a matter of fiduciary duty does not in itself automatically lead to significant changes in pension trustees' behaviour. Forthcoming

---

[1] http://www.fclt.org/en/home.html

[2] Urwin, R. and Woods, C. (2009) Sustainable Investing Principles: Models for Institutional Investors. Available at http://uksif.org/wp-content/uploads/2012/12/URWIN-R.-and-WOODS-C.-2009.-Sustainable-Investing-Principles-Models-for-Institutional-Investors.pdf

[3] California Public Employees' Retirement System. (2014). Statement of Investment Policy for Investment Beliefs. Available at http://www.calpers.ca.gov/eip-docs/investments/policies/invo-policy-statement/investment-beliefs.pdf

research by the UNEP Inquiry into the Design of a Sustainable Financial System finds that a critical obstacle to the adoption of a longer-term orientation and more substantial incorporation of relevant ESG issues into decisions is to be found in pension funds' available 'governance budget' – that is to say the available time, expertise and decision-making capacity. We believe the same problem exists in the UK – albeit perhaps to a lesser extent.

It is important that trustees have the requisite skills and knowledge to enable them to develop investment beliefs and strategies that strike the appropriate balance between long and short-term objectives, and to ensure alignment of the investment chain with these objectives. **We therefore recommend that The Pensions Regulator strengthen its trustee toolkit to reflect the approach set out here, and that it devote greater attention to ensuring that trustees have and maintain the necessary knowledge and skills. For example, pension funds could be required to provide annual statements on how they have identified and met trustee training needs, as is the case in Australia.**

Consultation Question 2 – Do you agree that amending the Investment Regulations to require trustees to comply with the current requirements in the Stewardship Code, or explain why they have not done so, is the most appropriatee way to implement the Law Commission's recommendation?

No.

The Stewardship Code does not directly address pension trustees. The links between trustees and their investment consultants on the one hand and their external asset managers on the other - an area that was strangely overlooked in the Kay Review - are critical to the promotion of greater long-term investment. The extent to which trustees seek advice on long-term investment strategy from their consultants; give investment mandates with a long-term orientation to their asset managers; and monitor their managers with a long-term focus rather than a short-term performance view, including the managers' implementation of the Stewardship Code, is vital in the stimulation of long-term investment and stewardship.

The Regulations should require trustees to explain how they reflect their long-term objectives in their relationships with their investment consultants and their asset managers, including how they monitor their asset managers to encourage implementation of the Stewardship Code.

I hope these comments and suggestions are helpful.

Yours sincerely,

Rob Lake.

Rob Lake
Independent Responsible Investment Advisor