April 2015

Pension Protection Fund Response

DWP Consultation on changes to the Investment Regulations following the Law Commissions report 'Fiduciary Duties of Investment Intermediaries.

1.0 Introduction

1.1 We welcome the opportunity to respond to the consultation on changes to Investment Regulations subsequent to the Law Commissions report 'Fiduciary Duties of Investment Intermediaries'. The focus of our comments are based on our experience as an asset owner with a commitment to responsible investment and development of best practice initiatives.

1.2 We hope that our experience in the pensions' arena and our response to the questions raised will aid DWP's thinking on investment regulation as it evolves further. We are happy to engage in any further dialogue to share our experience and to assist in this matter.

2.0 About us

2.1 The Pension Protection Fund (PPF) was established by the Pensions Act 2004 to provide compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer, and where there are insufficient assets in the pension scheme to cover the PPF level of compensation. The Fund is administered by the Board of the PPF, a public corporation.

The PPF is funded by four main sources of income. These include:

- an annual Pension Protection Levy paid by eligible pension schemes;
- recoveries of money, and other assets, from insolvent employers of schemes taken on by the PPF;
- taking on the assets of schemes that transfer to the PPF; and
- returns on the PPF's own investments

2.2 The PPF is not a pension scheme in its own right. The Board of the PPF is a statutory body subject to public law rather than trustee duties. Much of the detailed regulation applicable to pension schemes was carried across to the legislation setting up the PPF with minimal changes. As a result, and supported by legal advice, we do not regard the position on ESG and

Ethical issues for us as a statutory body to be radically different from that of trustees.

2.3 The PPF has c.£20 billion of assets under management and our award winning approach places us in the vanguard of pension scheme investment strategies. We respond to this consultation because we consider the proposals are relevant to the health of our protected population (i.e. of those UK pension schemes whose members we protect), and to the stability of financial markets more generally.

2.4 In setting and implementing our investment strategy our primary concern is to act in the best financial interest of our members, by seeking the best return that is consistent with a prudent and appropriate level of risk. Our Statement of Investment Principles also recognises that:

- by acting as a responsible and vigilant asset owner and market participant, we can protect and enhance the value of our investments; and
- ESG factors can have an impact on the long-term performance of our investments, and the management of ESG risks and exploitation of ESG opportunities can therefore add value to our portfolio.

2.5 The same belief applies, by extension, to the investments of our protected population, and in particular those schemes that are in assessment, i.e. are likely to transfer their schemes assets and liabilities to the PPF.

2.6 Schemes that are in a PPF assessment period (to establish whether they are sufficiently funded to pay members benefits at PPF levels of compensation) are included on our Balance Sheet, and there are legislative controls to prevent actions that could increase their protected liabilities. Although it is undesirable for the PPF to be exposed to financial risk such as ESG risks that have not been identified or addressed by the schemes' trustees when they enter the assessment period, we do not impose our views on ESG factors on such schemes. We do, however, work closely with schemes to help them better understand and mitigate their risks, where appropriate.

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

3.1 Our view is that clarifying between financial and non-financial factors could serve as a useful distinction for trustees however only to the extent where distinctions sufficiently support their ability to confidently perform the full extent of their fiduciary duties. This is required as our general engagement with industry tells us that a proportion of trustees remain confused on trustee fiduciary duty on environmental, social, and governance factors (ESG). Equally we also believe that clarity is best achieved through the process of discussion, evaluation and judgement when taking a holistic view on the wide ranging factors in investment decision making.

3.2 ESG factors should be considered as 'financial' and should be used as a core factor of risk management. Our core belief remains that ESG factors can have an impact on the long-term performance on investments, and the management of ESG risks and exploitation of ESG opportunities can therefore add value to investment return as well as serving to protect investment returns.

3.3 On the other hand "Non-financial" factors (i.e. ethical factors) should be viewed as those factors focused on the desire to safeguard and enhance a pension funds reputation in line with the beliefs of its beneficiaries (although this is less clear in the case of the PPF given our statutory basis). A key reason for a factor to be considered "non-financial" must be that the source of motivation for it is independent of any anticipated influence, over any time period, on investment returns potential. A clear distinction is namely one of "values" vs. "value" when determining whether a factor should be viewed as "financial" or "non-financial".

4.0 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 appropriate way to implement the Law Commission's recommendation? If not, what approach would be more appropriate to encourage trustees to consider their approach to stewardship?***

4.1 We deem it necessary to clarify and strengthen the duty of investment intermediaries to their stakeholders, this is with a view to ease any confusion on responsibilities. We are however cognisant of the Law Commissions position that "any attempt to change fiduciary duty through legislation would result in new uncertainties and could have unintended consequences".

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4.2 Our observation is that the existing structure and content of the Stewardship Code is more aligned to the activities and responsibilities of asset managers. This varies from those of assets owners such as pension fund trustees.

4.3 We sense that requesting asset owners to "comply or explain" with the Stewardship Code in its current structure may risk a compliance approach. Such an approach may result in confusion with regards to what their responsibilities are.

4.4 As long-term asset owners we believe that there is value to be gained for long-term performance by behaving as active owners of the assets we are invested in. Exercising our shareholder rights is not an end in itself but an essential means of ensuring that boards are accountable, and are fulfilling their stewardship obligations to shareholders, including the delivery of long-term value. This is why we have adopted a Statement of Stewardship Principles which sets out our beliefs and principles that underpin our role as a shareholder in listed companies.

4.5 Asset owners should be compelled to 'consider' the Stewardship Code as part of defining their own approach to Responsible Investment. We would propose a more flexible requirement, e.g. describe 'your policy', if any, with respect to the incorporation of stewardship activities when selecting, appointing and reviewing the performance of asset manager's. Considerations should however be given to differences in asset classes with regards to relevance and availability of best practice.

4.6 As described above we are supportive of updating the current language as proposed by requesting trustees include a statement within the SIP of their policy on: i) how they assess long-term risks, inclusive of ESG and other factors which may be financially material to the performance of their investments; and ii) defining whether and in what situations it would be appropriate to make investment decisions on the basis of non-financial factors.

4.7 The Stewardship Code requires further development as highlighted above to better align with the activities and responsibilities of asset owners such as pension scheme trustee. Over time through evolution of the current Stewardship Code via further engagement and addressing the specific circumstances of assets owners and asset managers there is scope for adopting a more formal 'comply or explain' approach.

5.0 Consultation Question 3: *What steps would trustees need to take to comply with any amendments to the Investment Regulations, as set out in Chapter 2? What, if any, costs would be involved in meeting any new requirements*?

5.1 As the PPF is not a pension fund in its own right, our comments are once again centred on our engagement experience with the industry. We believe the question posed is a challenging one as there are a numerous constituents which may impact the cost to trustees and beneficiaries to an extent. Similarly there are also broader internal process and governance factors that will need to be considered. Careful consideration should be given to the ability of small schemes (by number of members) to comply with any changes.

5.2 We would certainly envisage that in the first instance there would be upfront cost of establishing if sufficient resources exists to consider how stewardship activities or integration of ESG factors can be embedded within the investment decision making process (assuming a policy does not already exist). Costs are however mainly realised at implementation stage which will vary across varying pension fund sizes and further influenced by the purpose set out by trustees.

5.3 Delving more specifically at implementation there are several options available as outlined below :

a. Developing in-house capabilities to execute stewardship activities
b. Outsourcing full time stewardship responsibility to a third party overlay service provider
c. Collaboration with other pension funds (or asset owner community as a whole) through pooling of resources to benefit from greater scale, influence and efficiencies

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6. Further information

The PPF would be happy to discuss the points we have made in our submission in more detail. Please contact:

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