MERCER INVESTMENTS RESPONSE TO DWP CONSULTATION ON CHANGES TO THE INVESTMENT REGULATIONS FOLLOWING THE LAW COMMISSION REPORT ON 'FIDUCIARY DUTIES OF INVESTMENT INTERMEDIARIES'

1. Introduction

Mercer is a leading global provider of investment advice and services, offering customised guidance at each stage of the investment decision, risk management, and investment monitoring process. Our Investments business includes a specialist global Responsible Investment (RI) team which caters to an increasing demand from clients for advice on the integration of environmental, social and corporate governance (“ESG”) issues into investment decision-making.

Members of the RI team work closely with colleagues in Mercer’s manager research, client consulting and fiduciary management teams to ensure that ESG considerations are included in, for example, assessments of investment managers and in the advice we provide to clients. In the UK, the RI team increasingly provides stewardship advice to clients in a variety of ways, highlights of which are provided below:

- Mercer was the first major investment consulting firm to sign up to the UK Stewardship Code (“the Code”) on its publication in 2010;
- Since the publication of the Code Mercer has proactively advised UK clients to update their statements of investment principles (“SIPs”) to include reference to the Code, including how they are exercising their stewardship duties on behalf of beneficiaries;
- Mercer’s RI team regularly conducts research (on behalf of its UK clients) on the stewardship capabilities of investment managers – which provides useful input to manager selection and monitoring.
- The RI team also regularly conducts trustee training sessions on the relevance and value of “good stewardship” and the materiality of ESG issues;
- Since 2008 Mercer has produced strategy-level “ESG Ratings”. These ratings assess the ESG integration capabilities of investment managers, including how managers approach active ownership, a key part of stewardship.

2. Mercer’s response to the consultation

Mercer welcomes the DWP’s consultation on changes to the UK Investment Regulations. This document provides our response to the three questions posed in the consultation document.

Question 1 – How could regulation 2(3)(b) of the Inv Regs be amended so that it more clearly reflects the distinction between financial and non-financial information?

Mercer understands the motivations in defining the difference between material ESG issues and more subjective (but less obviously material) ethical issues. Our concern is that in practice the nuances of these distinctions will be lost. In short, codifying the phrase “non-financial” in the Investment Regulations (“the Regulations”) is likely to be unhelpful and work against ESG integration as trustees may interpret “non-financial” to mean “irrelevant”.

Issues that are simply “non-traditional” (i.e. not readily quantified on company balance sheets or in annual pension scheme accounts) could fall under the term “non-financial” and risk being ignored when they are or could be both financially material and of significant concern and relevance to pension scheme sponsors and scheme members.

In our experience, the way in which ESG issues are framed and presented is a determining factor in how trustees view the relevance of these issues, and consequently how systematically ESG issues are considered in ongoing investment activities. The Law Commission provided helpful comments in this regard in its 2014 guidance document for pension scheme trustees i.e. *“Trustees may take account of any financial factor which is relevant to the performance of an investment. These include risks to a company’s long-term sustainability, such as environmental, social or governance factors (often referred to as “ESG” factors)”*.

The consultation document suggests that trustees should be required to state their policy on how they evaluate long-term risks “including ESG and other factors which may be financially material to the performance over their investments”. We think this would be a useful requirement if it leads to trustees genuinely considering ESG issues as we believe there is value in doing so. To avoid a box-ticking approach being adopted by trustees to comply with the proposed Regulations, we would go further and suggest that trustees are required to also state the means by which their policy to evaluate ESG risks is or will be implemented, including an expected time frame for:

- The initial implementation of the scheme’s policy (given that it could involve new elements for many schemes), and

- An ongoing review period within which trustees are required to both reconsider and communicate their views to scheme members and the sponsor.

Experience has shown us that meaningful implementation is more likely when investors are required to provide evidence of activity, rather than simply indicating the existence of a policy.

Further, trustees are likely to need reassurance that by acting on ESG and/or ethical issues – for example by considering how different investment managers assess and manage these issues in day to day portfolio management and selecting managers more explicitly on this basis – they will not be in breach of the Regulations. Rather than focusing on definitions of “financial” and “non-financial” the DWP may find it more useful to consider guidance for trustees to provide the above reassurance.

However, Mercer does support the need to review and amend the references to ESG issues in the Regulations to reflect current custom and practice in this area. The language and terminology in this area can be confusing for trustees, not least because it is evolving rapidly. For this reason we recommend avoiding the word “ethical” and using the phrase “ESG” as a catch-all term for issues that are potentially material but not adequately captured in investment analysis.

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?

Mercer was an early adopter of the the Code and has proactively raised the importance of stewardship with UK pension scheme clients since the Code was first created in 2010. The core of our stewardship advice is an assessment of manager stewardship capabilities using the seven principles of the Code as the starting point. These assessments also include deeper analysis of the quality of the voting and engagement activities that underpin the exercise of stewardship duties by third party investment managers. Our assessments provide clients with a clear view of the variation amongst their appointed managers in the implementation of stewardship duties on their behalf. This information is a valuable input into our clients’ own assessments – using a variety of metrics – of the value that their managers bring.

Amending the Regulations to require trustees to comply or explain with the requirements of the Code would provide additional weight to the Code. It would also be a positive step in ensuring that pension schemes – in addition to investment managers – are demonstrating how they are exercising their broader duties to members. The ideal outcome from this amendment would be that more asset owners communicate the importance of stewardship to their investment managers – in particular through appointment and monitoring processes – further stimulating demand for improved stewardship in the investment chain.

The “comply or explain” regime attached to the Code is a practical means of allowing for variety in how stewardship duties are exercised – both by asset owners and investment managers.

Many defined benefit pension schemes may find the cost-benefit equation does not support devoting significant time to active stewardship – for example for schemes in advanced stages of de-risking with limited direct exposure to listed equities. However many – in particular defined contribution – schemes should see the value in stewardship. In light of this, the DWP should consider ways in which to encourage meaningful explanations of ‘non-compliance’ with the Code. One approach to this could be guidance to trustees, by providing examples of high quality explanations against the Code that have been provided to the Financial Reporting Council in existing ‘statements of commitment’ to the Code.

Question 3 – What steps would trustees need to take to comply with any amendments to the Investment Regulations (as set out in the consultation)? What if any costs would be involved in meeting any new requirements?

The time and resources available to most UK pension schemes are limited and additional demands on these resources – and trustees in general – should be carefully considered. However, the proposals provided by the DWP, in particular around stewardship (and if approached thoughtfully by trustees) should have the effect of supporting existing risk management activities. Our belief is that good stewardship and active ownership, properly executed, supports the value creation process provided by well run, sustainable companies which in turn supports the objectives of long-term investors such as pension schemes.

Mercer’s view is that most of the DWP’s proposed amendments would not require significant additional costs for pension schemes. As already outlined above, the challenge is ensuring that policy (or similar) statements are supported by the appropriate implementation activities so that meaningful activity can be demonstrated to scheme members, and if necessary publicly. Overall our view is that any costs associated with the thoughtful application of stewardship would be outweighed by the long-term benefits to schemes and their members.

Mercer
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