Consultation response
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Proposed changes to investment regulations

Introduction

Aon Hewitt is pleased to submit its response to the DWP's consultation on changes to the Investment Regulations following the Law Commission's report on 'Fiduciary Duties of Investment Intermediaries'.

By way of background, Aon Hewitt is a global company providing human resource consulting and outsourcing solutions with more than 30,000 professionals in 90 countries.

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?

Our position: In our view, in order for trustees to adequately capture a full range of financial and non-financial factors, they need to place more emphasis on the potential outcomes over their long term strategic horizon rather than focusing purely on the shorter term implementation horizon. Factors that could be financially material over the trustees' strategic horizon are ignored because they are not expected to be financially material over the short term.

In our experience, trustees do make strategic decisions over a long (more than 10 year) horizon but are faced by factors which compel them to take a short-term view of their investments and constrain their investment strategy – for instance:

- Accounting regulations require annual 'mark to market' valuations and as a result sponsors and trustees seek to reduce funding level volatility by reducing their exposure to the more volatile asset classes (including equities).

- The majority of corporate DB pension plans are now closed and have become a risk management (rather than an HR) issue for sponsoring companies. As a result, sponsors are increasingly looking for the smoothest achievable path to an exit from their legacy pension liability. Once again, this typically involves substantial de-risking away from growth assets – either immediately or over a relatively short time horizon. There is no benefit to the sponsor in achieving an over-funded scheme (surplus).

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We believe that changing the requirements of the Statement of Investment Principles to cover financial and non-financial factors will enable trustees to distinguish better between factors that do genuinely require focus on shorter time horizons and those which more properly require a greater long term focus in decision making. By moving this onto trustees' agendas it should encourage trustees to focus on the longer term impacts of their decisions where such a longer term focus is appropriate. However, our expectation is that the proposed changes will only lead to a very gradual move in the right direction.

At this point we would note that, while the debate about Environmental, Social and Governance (ESG) factors typically focusses on equity investments, in our opinion long-term financial factors are important for a wide range of assets, including some which are increasingly found in so-called low risk portfolios (such as corporate bonds, real estate, overseas bonds, etc.).

We believe that the long-term survival and success of an enterprise requires a sufficient awareness and management of both long-term and short-term risks and opportunities. We would draw a parallel between a pension plan and a company, and we note the FRC's 2014 Guidance on Risk Management, Internal Control and Related Financial and Business Reporting where, in the first paragraph of 'Background' to the Guidance, it states that "Effective development and delivery of a company's *strategic objectives*, its ability to seize *new opportunities* and to ensure its *longer term survival* depend upon its identification, understanding of, and response to, the risks it faces" (our emphasis). We believe that this statement is equally true of pension plans.

Furthermore, we agree with the Law Commission that non-financial factors (such as improving members' quality of life) can have a role to play in trustees' decision-making processes, to the extent that they complement, and do not supersede, financial factors. An example might be if the trustees of a Local Government Pension Scheme were to decide to invest in local social housing, or to provide local venture capital, if it was done in a sufficiently robust way with expected risk-adjusted returns that are comparable to those from a more national or international approach.

Our proposal: We suggest that the current reference to 'social, environmental or ethical considerations' should be removed. Instead we suggest that trustees could be required to state:

- How they ensure that both short-term and long-term financial risks and opportunities (i.e. those which may be financially material) are captured in their investment decisions, or those of their agents

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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?**	**Our position**: We believe that well-governed companies outperform poorly governed ones on a risk-adjusted basis. We support the Stewardship Code and we encourage our clients to adopt it. However we recognise that, as with any set of simple principles, there is the potential for unintended consequences. For example, we are concerned that some asset managers are insufficiently well resourced to carry out meaningful analysis or consideration of the full range of voting issues across all their portfolios, and yet feel compelled by the Code to vote every resolution for every share they own. This has the danger of leading to a high proportion of 'thoughtless' or purely passive voting (that is, simply following the direction provided by a third party) without considering adequately the implications for their own investment thesis. Nevertheless, we believe that the Code is a very helpful expression of shareholder responsibilities and we hope that any unintended consequences will be ironed out over time. **Our proposal**: We support the proposal that trustees should be required to 'comply or explain' with the Stewardship Code.
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?**	We do not believe that the proposed changes which we have outlined above would be unduly onerous for trustees. ▪ Some of our recommendations under Question 1 would lead only to increased discussion with, and scrutiny of, the trustees' delegated agents (asset managers, etc). ▪ Increased communication to members can, in many cases, be achieved either online and/or via the scheme's annual report.

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- Capturing a range of long-term financial risks in strategic decisions is slightly more problematic since those decisions are typically taken on the basis of forward-looking modelling and analysis, and the impact of many long-term risks is notoriously hard to quantify. However we believe that a pragmatic approach to this point (involving qualitative discussion alongside quantitative modelling) would be appropriate.

- The decision whether to embrace non-financial factors is one that is likely to lead to increased cost since the trustees will need to be able to prove that they have carefully evaluated the potential financial impact of such a decision. Nevertheless, we believe that this evaluation can be carried out as part of the overall strategic asset allocation decision and that the additional cost will be modest.

- Similarly, under Question 2, supporting the Stewardship Code is not (in our experience) onerous and the principal additional burden on trustees lies in the additional monitoring of asset managers that is required. For large schemes, with multiple equity managers, the trustees may prefer to commission a third party to consolidate either the reporting of voting / engagement activity, or indeed the actual activity itself. This would clearly incur some additional cost. However we believe that such activity is likely to add value net of fees in the long-term (since well governed companies are expected to outperform poorly governed ones).