BT Pension Scheme

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Mr Elias Koufou
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By e-mail to: REINVIGORATING.PENSIONS@DWP.GSI.GOV.UK

Changes to the Investment Regulations following the Law Commission's report 'Fiduciary Duties of Investment Intermediaries'

Dear Mr Koufou

We welcome the opportunity to respond to DWP's consultation on changes to the Investment Regulations following the Law Commission's report 'Fiduciary Duties of Investment Intermediaries'.

By way of background, the BT Pension Scheme (BTPS or the Scheme) is the UK's largest corporate Defined Benefit (DB) pension scheme with assets of over £40 billion (as of 30 June 2014).

We believe the definition of fiduciary duty is clearly understood: acting in the best shared interests of scheme beneficiaries. Understanding what is in the best shared interests of scheme beneficiaries requires consideration of a wide-range of both short and long-term factors, including environmental, social and governance (ESG). We consider ESG factors in so far as they are relevant to the risk-adjusted returns of an investment and do not invest solely on the basis of ESG factors.

We have included a statement on responsible investment in the Scheme's Statement of Investment Principles for some time and have long-recognised that these activities are critical in protecting and enhancing the long term value of our investments.

It is also important to highlight that, like many DB schemes with pensions in payment, we need to invest with careful consideration of our current, ongoing and future liquidity requirements. We therefore invest in assets with a range of maturities and / or expected holding periods to ensure we can meet current and future cash flow requirements and to balance risk in the Scheme. Consequently, only a relatively small proportion of the Scheme's asset portfolio can be invested in assets with long expected holding periods, and compliance with the Stewardship Code is likely only to be relevant to a small part of the Scheme's asset portfolio. With this in mind we would be concerned if a regulatory framework was developed that placed disproportionate emphasis on holding often illiquid assets over the longer term as this could be to the detriment of pension scheme liquidity and risk management.

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We also suggest that a balance should be considered between the effort to comply with any proposed regulation and the size of the scheme to which it is applicable. Smaller schemes in particular are unlikely to be sufficiently well resourced to be able to comply with more onerous regulation without

there being an impact on their cost structure. As pointed out above, not all schemes have the same maturity profiles and this regulation is likely to be more applicable to some schemes more than others.

We answer the specific questions raised in the consultation below and would welcome a further conversation with the DWP as its thinking develops in this area.

Yours sincerely

Eileen Haughey
Chief Executive Officer

Enc: Consultation questions

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Consultation questions

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?**

We think that clarifying between financial and non-financial factors could be a helpful distinction for trustees only to the extent that this distinction supports their ability to confidently and fully execute their duties in the interests of the members of their scheme.

We do not believe that clarity is best achieved through the strict labelling of certain types of factors as 'financial' and others as 'non-financial' but rather through the process of evaluation, discussion and judgement behind the integration of a wide-range of factors in investment decision-making.

We do not believe that environmental, social, or governance (ESG) factors are in fact 'non-financial'. While these factors may not always be quantifiable and might have implications over a longer time horizon there is an increasing body of evidence to demonstrate not only that they have a bearing on financial performance but that some activities, including active stewardship, can positively influence long-term risk adjusted returns. In our view this is best implemented by a combination of integration of ESG factors as part of the investment process and through active stewardship of portfolio companies and assets.

We welcome the fact that the Law Commission wishes to remove any misconception between 'financial' and 'non-financial' factors. We are of the view that trustees should have the option to take these factors into account depending on how compelling they consider the evidence of their impact to be and whether they consider they are relevant to the interests of their members.

The Law Commission could clarify that if ESG factors are believed to influence long-term value and, if engagement with companies is believed to help to reduce long-term risk and increase value, then trustees already have a fiduciary obligation to take ESG factors into account and disclose how they are doing so.

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?**

We do think there is a case for clarifying and in some cases strengthening the duty of investment intermediaries to their clients, but sympathise with the previously stated position of the Law Commission that "any attempt to change fiduciary duty through legislation would result in new uncertainties and could have unintended consequences".

However, it is important to provide greater clarity on the interpretation of the general law of fiduciary duties such that these are consistent with the aim of promoting behaviours aligned to pension funds' investment objectives.

Many DB schemes with pensions in payment need to invest with careful consideration of current, ongoing and future liquidity requirements. Pension schemes invest in assets with a range of maturities or expected holding periods to ensure that they can meet current and future cash flow requirements and to balance scheme risk. In this context, often only part of a scheme's asset portfolio can be invested in assets with long expected holding periods. Consequently, compliance with the Stewardship Code might only be relevant for a small proportion of a scheme's asset

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portfolio. With this in mind we would be concerned if a regulatory framework was developed that placed disproportionate emphasis on holding often illiquid assets over the longer term.

We note that in many ways the structure and wording of the current Stewardship Code is geared towards the specific activities and responsibilities of asset managers, which vary from those of pension fund trustees as asset owners.

As such we are reticent about supporting the current proposal as we feel asking asset owners to 'comply or explain' with the Stewardship Code in its current form may risk a compliance approach resulting in undue confusion as to what their responsibilities are.

Asset owners are increasingly considering the value to be gained for long-term performance from behaving as active owners of the assets in which they are invested. In essence, stewardship is working with the underlying assets to ensure they focus on delivering risk-adjusted value over time. Some asset owners hire specialist firms to do this work, some undertake these activities directly and many expect this to be part of the process of active fund management as defined in the current iteration of the Stewardship Code.

The Law Commission previously recommended that trustees should be encouraged to consider whether and how to carry out their stewardship responsibilities – engagement with investee companies and exercising of voting rights - either directly or through their investment managers. The report recommended including a specific requirement for the fund's Statement of Investment Principles (SIP) to contain a statement of the trustees' policy (if any) on stewardship.

In the Government's response to the Law Commission's report it committed to consulting on changes to the Investment Regulations to require trustees to state their policy (if any) on stewardship in the SIP, suggesting this should mirror what is set out in the current principles and guidance requiring trustees to report against the Stewardship Code and we are broadly supportive of such an approach.

The effect of this, it is suggested, would be a requirement on trustees to state in their SIP:

- that they have signed up to the Stewardship Code, or explain why they considered this was not relevant to them in discharging their investment duties; and
- if they have signed up to the Code, how they comply with the principles of the Code, or explain to what extent, and on what grounds their approach departs from these principles.

To this question we are supportive of updating the current language as suggested by requiring trustees to include a statement within the SIP of their policy on a) how they evaluate long-term risks, including from ESG and other factors which may be financially material to the performance over their investments and b) determining whether and in what circumstances it would be appropriate to make investment decisions on the basis of non-financial factors similar to what is described above.

While adopting a strict 'comply or explain' requirement for trustees to describe their efforts to comply with the explicit requirements of the Stewardship Code as recommended by the Law Commission may not currently be the most effective course - all asset owners should be encouraged to 'explain' their approach to the key described above.

We also suggest that a balance should be considered between the effort to comply with any proposed regulation and the size of the scheme to which it is applicable. Smaller schemes in particular are unlikely to be sufficiently well resourced to be able to comply with more onerous

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regulation without there being an impact on their cost structure. As pointed out above, not all schemes have the same maturity profiles and this regulation is likely to be more applicable to some schemes more than others.

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?**

This is a difficult question to answer precisely due to the large number of variables which may impact the ultimate cost to trustees and beneficiaries.

There is no inherent cost in trustee's considering what stewardship activities they may undertake or how ESG factors might be incorporated into their funds' decision making process. The cost is realized at the implementation stage, which will vary significantly from fund to fund based on the determinations made by the trustees.

In practice, this can take several different forms from developing a specialised in-house resource to deploy the fund's ESG integration and stewardship work, to outsourcing these responsibilities to third party service providers on a full time basis, to simply retaining the services of consultants on an ad-hoc basis.

Some asset owners have found it is possible to implement a cost-effective approach to stewardship, particularly for passive equity portfolios, by pooling resources thereby giving them greater scale and influence with portfolio companies.