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Dear Sinead and Vicky

Consultation on clarifying and strengthening trustees' investment duties

I set out below the response of British Airways Pensions Services Limited (BAPSL) and British Airways Pension Investment Management Limited (BAPIML) to the consultation document. BAPSL provides in-house pensions administration and governance services to the Airways Pension Scheme and the New Airways Pension Scheme, which are two large defined benefit schemes for current and former employees of British Airways and other group companies, and have assets with a combined value of around £25 billion. BAPIML manages the investments of these schemes.

***Question 1**: We propose that the draft Regulations come into force approximately one year after laying, with the exception of the implementation report, which would come into force approximately 2 years after laying.*

a) Do you agree with our proposals?

We agree that this is an appropriate timeframe.

b) Do you agree that the draft Regulations meet the policy intent?

We agree that the draft Regulations meet the above policy intent.

***Question 2**: We propose to require all trustees of all schemes, which are obliged to produce a SIP, to state their policy in relation to financially material considerations, including, but not limited to,*

The Airways Pension Scheme and the New Airways Pension Scheme
Airways Pension Scheme Trustee Limited Registered in England and Wales No 10300010
New Airways Pension Scheme Trustee Limited Registered in England and Wales No 10299954
British Airways Pension Trustees Limited Registered in England and Wales No. 453632
British Airways Pension Services Limited Registered in England and Wales No. 3123736
British Airways Pension Investment Management Limited (authorised and regulated by the FCA) Registered in England and Wales No. 2220777
Registered Offices as above

those resulting from environmental, social and governance considerations, including climate change.

a) Do you agree with the policy proposal?

We agree with the Law Commission's findings that the current language of Regulation 2(3)(b)(vi) of the Occupational Pension Schemes (Investment) Regulations (the "Investment Regulations" has been a source of confusion for pension trustees. The proposed replacement of the current wording in the regulation with a reference to "environmental, social and governance considerations" (ESG) will be helpful to displace this confusion and in particular the conflation in the current wording of the regulations of "environmental and social" considerations (which may frequently be of material financial relevance to a pension scheme's investments) with "ethical" considerations (which are more likely to be a non-financial factor).

We have no objection to the removal of the current "(if at all)" wording in Regulation 2(3)(b)(vi), as we recognise that it is now reasonably clear that, where ESG considerations are financially material to a pension scheme's investments, they ought to be taken into account.

We also have no objection to the specific reference to climate change in the reference to ESG considerations in the regulations. Technically, we are not sure that it is necessary to make an explicit reference to it (because we consider that it is covered already), but we recognise that there may be a desire from a policy point of view to highlight this as a relevant factor.

b) Do the draft Regulations meet the policy intent?

We consider that the draft Regulations generally meet the policy intent and, as noted above, agree that Regulation 2(3)(b)(vi) of the Investment Regulations will be improved by making reference to ESG considerations (including climate change) rather than the current wording. However, we do have a number of concerns over the current drafting as follows:

(i) Defining ESG considerations within a broader heading of "financially material considerations". Whilst we can see why the draft Regulations have been drafted this way to reflect the distinction drawn by the Law Commission between financial and non-financial factors and the possibility that "ESG" could in future become an outmoded term, we think that defining ESG considerations simply as a subset of a wider definition of "financially material considerations" may have a number of disadvantages and possible unintended consequences. As currently drafted, the amended Regulation 2(3)(b)(vi) of the Investment Regulations would require trustees to have a policy on <u>all</u> matters that might be financially material to the performance of the scheme's investments. This could be a very extensive list. Taken literally we think there is a risk that some trustees may seek to comply with this by providing long generic lists of all matters that might affect a scheme's

investments. This could significantly detract from two of the policy intentions expressed in the consultation of encouraging trustees to focus on financially material ESG and climate change risks and making SIPs less generic.

Accordingly our preference would be to refer to "environmental, social and governance" in Regulation 2(3)(b)(vi). We also note that the ESG terminology is used without definition in IORP II .

(ii) The use of the word "includes" within the definition of "financially material considerations". The way the definition of "financially material considerations" is drafted, when read narrowly, suggests that ESG factors will always be considered to be financially material (whether in fact they are financially material or not). We do not think that this is the policy intent as there will likely be some ESG factors that are not financially material within the circumstances of any given pension scheme. The current wording of the draft regulations does not cater for this possibility. We think that the intention is for ESG factors to be a non-exhaustive subset of considerations for trustees where financially material. This could be addressed by further refinement of the definition of "financially material considerations" so that it includes ESG (including climate change only where financially material).

***Question 3**: When trustees prepare or revise a SIP, we propose that they should be required to prepare a statement, setting out how they will take account of scheme members' views.*

a) Do you agree with the policy proposal?

We can foresee significant practical issues with this element of the proposals under the consultation in relation to member views on non-financial matters. These are as follows:

- Encouraging of member surveys.

  We are aware that many have read the consultation as an indication that the DWP wishes to encourage trustees to seek member views on non-financial matters. We recognise that the draft Regulations are not intended to impose any requirement on schemes generally to do this. However, we think that there is a significant risk of misinterpretation and false expectations being raised among pension scheme members as trustees will ask themselves how they are supposed to hold a "reasonable opinion" on the views of members without having gone to some lengths to find out what those views are (even if they are not obliged to take those views into account). This is likely to make it difficult for schemes which, quite legitimately and in line with their fiduciary duties, do not and in many cases legally

cannot take them into account. We consider that this will be the vast majority of occupational schemes and particularly defined benefit schemes. The case law indicates that the legal ability of trustees to take member's views on non financial factors into account is likely to be extremely limited (on which see further below). The requirement for a member views statement will suggest otherwise, and will lead to a concern on the part of trustees that they will be faced with criticism from members claiming either that they ought to be taking their views into account (where they have said that they will not do so) or that they are not adequately doing so (where they have said that they will).

- Further confusion between ESG and ethical matters

  We consider that there is a real danger of trustees becoming side-tracked on member views on non-financial matters rather than focusing on ESG and climate change as material financial considerations. As noted above, we consider that the current regulations may have already caused trustees to conflate non-financial ethical issues with financially material ESG and climate change issues. We think a requirement for member statements on ethical matters may further muddy the waters. Trustee governance time is also limited for most schemes. We consider that experience may run contrary to the policy objectives if trustees divert time and attention on member ethical views at the expense of considering ESG factors as part of their fiduciary duties.

- Limited practical relevance of non-financial factors

  As mentioned above, case law has held that the circumstances in which it is appropriate for trustees to take non-financial factors, including the views of members, into account are very limited.

  The first case which considered the issue (*Cowan v Scargill*, in 1985) held that the circumstances in which it might be appropriate for trustees to take into account non-financial factors are "very rare", where "the only actual or potential beneficiaries of a trust are all adults with very strict views on moral and social matters" – conditions which in practice are simply not going to be met, except in a few rare small schemes.

  The Law Commission in its 2014 report did also refer to the 1996 case of *Harries v Church Commissioners*, but the judge in that case emphasised the difference between a charity (which that case was about) and a pension fund, and furthermore he held that it was appropriate for beneficiaries' views to be taken into account only where there was no risk of "significant financial detriment". In practice it is going to be difficult for pension trustees to determine whether any factor that they take into account entails a risk of financial detriment, and if it does, whether that risk is significant, that, even if this decision did

constitute binding authority for pension schemes (which it does not) the circumstances in which it gives sufficient latitude for trustees to take non-financial factors into account are vanishingly small.

This supports the point we make above that specifically requiring pension schemes to state the extent to which members' views are taken into account elevates the significance of that issue to a higher level than it ought to have, given that the circumstances in which trustees will be able to take those views into account (at least in a defined benefit context) are very rare.

- Distinguishing between member views in defined benefit and defined contribution schemes.

  The only money purchase benefits provided by the schemes we represent are attributable to additional voluntary contributions (AVCs). We note that the other proposals in the consultation that relate to money purchase benefits apply only to "relevant schemes", a category that would not include the schemes we represent as it excludes schemes in which the only money purchase benefits are attributable to AVCs. If a decision were taken to impose a different requirement in relation to taking members' views into account on the trustees of schemes with money purchase benefits from defined benefit schemes, that requirement would not apply to our schemes if the legislation were written in such a way as to capture "relevant schemes" only. We would support such a position given that it seems inappropriate to impose a more onerous requirement on trustees to take members' views into account in relation to their benefits derived from AVCs than their main scheme benefits.

b) Do the draft Regulations meet the policy intent?

See our comments above.

***Question 4**. Do you agree with our proposal not to require trustees to state a policy in relation to social impact investment? If not, what change in legislation would you propose, and how would you address this risk of trustee confusion on this point?*

We agree with the proposal and that it is likely to cause confusion to make further changes in relation to social impact investment before trustees have adjusted to and fully familiarised themselves with ESG issues more generally as a financially material risk issue.

***Question 5**: We propose that trustees should be required to include their policy in relation to stewardship of the investments (including monitoring, engagement and voting) in the SIP.*

a) Do you agree with the policy proposal?

We agree that it is sensible to view stewardship more widely than simply the exercise of voting rights as per the current wording of Regulation 2(3)(c) of the Investment Regulations.

b) *Do the draft Regulations meet the policy intent?*

We consider that the draft Regulations broadly meet the policy intent. However, we were unsure whether the level of detail specified in the definitions of "relevant matters" and "relevant persons" was strictly necessary. A broader reference to "engagement activities" may in our view suffice to meet the policy intent.

***Question 6**: When trustees of relevant schemes produce their annual report, we propose that they should be required to:*

- *prepare a statement setting out how they have implemented the policies in the SIP, and explaining and giving reasons for any change made to the SIP, and*

- *include this implementation statement and the latest statement outlining how trustees will take account of members' views in the annual report.*

a) Do you agree with the policy proposal?

We do not comment on this because, as stated above, the Airways Pension Scheme and the New Airways Pension Scheme are not relevant schemes.

b) Do the draft Regulations meet the policy intent?

See above.

***Question 7**: We propose that trustees of relevant schemes should be required to publish the SIP, the implementation report and the statement setting out how they will take account of members' views online and inform members of this in the annual benefits statement.*

a) Do you agree with the policy proposal?

As for Question 6.

b) Do the draft Regulations meet the policy intent?

See above.

***Question 8**: Do you have any comments on the business burdens and benefits and wider non-monetised impacts we have estimated in the draft impact assessment?*

In light of the comments above about the (possibly incorrect) inference that trustees are likely to draw that they should be ascertaining members' views where they do not already know them, we consider that the business burdens identified in the draft impact assessment are understated. Schemes that decide to obtain members' views will have costs associated with both the initial gathering of information and the subsequent monitoring of members' views (e.g. through a web portal), and also with the decision making about how to take those views into account once they are known. As stated above, the schemes in relation to which we are writing are large, but our resources are nonetheless stretched and any added governance entailed will be unwelcome.

We also consider that the impact is likely to be challenging for smaller schemes.

***Question 9**: Do you have any other comments on our policy proposals, or on the draft Regulations which seek to achieve them?*

No.

***Question 10**: Do you agree that the revised statutory guidance clearly explains what is expected of trustees in meeting their duty to publish the SIP, implementation statement and statement of members' views?*

We broadly agree.

Please direct any reply in this matter to *Richard Pilsworth at* Richard.Pilsworth@bapensions.com or at the address set out above.

Yours faithfully

Richard Pilsworth
Head of Legal and Governance