Institute and Faculty of Actuaries

Pension trustees: clarifying and strengthening investment duties

IFoA response to the Department for Work and Pensions

16 July 2018

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16 July 2018

Dear Sinead and Vicky,

Consultation on clarifying and strengthening trustees' investment duties

The Institute and Faculty of Actuaries (IFoA) welcomes this consultation. Overall, we are very supportive of the rationale for the proposed amendments and of the Government's intention to clarify that trustees can and should take account of environmental, social and governance (ESG) considerations where they are financially material.

We welcome the explicit mention of climate change as a financially material ESG consideration. The IFoA has worked to raise awareness around the financial risks posed by climate change, including issuing a Risk Alert for all members on the topic of climate change, last year. This is non-mandatory guidance that all actuaries should consider how climate-related risks affect the advice they are providing.

There are some areas in the consultation where we believe further consideration and/or clarification would be of benefit. We consider that the impact assessment underestimates the time needed to adequately understand and implement the requirements of the amended regulations, particularly as this is likely to be a new area of consideration for many trustees. We propose a phased approach allowing options to be explored in the market and giving schemes more than one year to revise their Statements of Investment Principles (SIPs) in respect of financially material risks. We would also welcome more guidance on trustees' duties and on how member views should be integrated. Although we support the intent of implementation statements, we do not agree with the policy proposal as this would result in additional costs being borne by trustees to prepare such a statement on an annual basis.

These points are explained in more detail in response to specific questions below.

Q1. We propose that the draft Regulation come into force approximately 1 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 are concerned that the proposed time period for requiring trustees to comply with the Regulations is too short and may result in some schemes producing revised SIPs quickly, but not necessarily well. We would encourage the Government to consider allowing schemes greater time to revise their SIPs in respect of financially material considerations and stewardship.

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

Our understanding is that the statement on member views would not need to be prepared until the first time the SIP is amended **after** the regulations come into force on (say) 1 October 2019. As such many schemes will not have prepared their first statement on member views before they are first required to produce an implementation report one year later.

Q2. 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, those resulting from ESG considerations, including climate change.

a) Do you agree with the policy proposal?

We agree with the consultation paper's account of the shortcomings of the current Investment Regulations in relation to financially material risks. We support the Government's decision to adopt the Law Commission's recommendations for trustees to state their policy on evaluating all financially material risks and opportunities. We also agree that this requirement should explicitly mention environmental, social and governance considerations, including climate change.

There is a long history of discussion about short-termism generally in markets, and this applies particularly in the case of pension funds, whose timeframes generally span several decades. We would encourage the Government to take this opportunity to ensure that the revised Regulations make clear that investment considerations – including, but not limited to, considerations around financial materiality of risks - should be made bearing in mind the investment horizons of the pension scheme.

b) Do the draft Regulations meet the policy intent?

The Government is not prescribing a particular format for the policy statement within the SIP, and we endorse that approach, but we do expect that many schemes – especially smaller and medium-sized schemes - will wish to adopt a fairly 'standard' statement. It will take some time for a standard to emerge as the larger or more influential schemes draft their policy statements. We would therefore propose a phased approach allowing options to be explored in the market and giving schemes more than one year to revise their SIPs in respect of financially material risks.

Q3. 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?**

In paragraph 2.24 of the consultation document, the Government notes it agrees with the Law Commission that "it is good practice to inform the design of investment strategies with an understanding of scheme members' views". We note the important difference between defined benefit pensions (where nearly all of the investment risk falls on the employer) and defined contribution pensions (where all of the investment risk falls on the member). We believe this should affect the extent to which trustees are encouraged to take members' views into account.

We welcome paragraph 2.32 of the consultation document which states: "If a trustee board has received or gathered evidence that members have, or are likely to have, a particular view on a non-financially material matter, they are free to consider whether or not they will act on this view". This is consistent with the Association of Pension Lawyers' view that the trustees' duty is to do what is right for members, which is not necessarily the same as acting on their views.

We support the proposed statement alongside the SIP, which would clarify how the trustees will implement any decision to act on the members' views, but not require them to take action on these views in the first place. While we agree that trustees should not be obliged to consider members' views, we believe the proposed statement would send a signal that it would be desirable for this to happen more often than it does now. We welcome the proposed requirement for trustees to articulate how they would implement members' views, which we believe will help to increase the overall level of responsiveness to those views. We believe the Government should consider if more detailed guidance for schemes is needed in this area. This would make it easier for trustees to produce a clear and coherent set of steps for assessing and acting upon members' views. In particular, such guidance could deal with the following issues:

- We suggest that the trustees' statement should clarify how they would reconcile the members' views with their financial goals in cases where these have the potential to be in conflict.
- The statement could clarify how the trustees would interpret their legal duty not to act on members' views if this would lead to 'significant financial detriment' to the scheme. Would this assessment be based on forward- or backward-looking analysis, and how would it take the cost of implementation into account?
- How to determine a consensus – for example, how large and how representative is the response to a survey, and has an appropriate question been asked?

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

The draft regulations refer to "the extent to which" rather than "how" members' views are taken into account, and hence do not quite achieve the stated policy intention.

We note that the draft regulations refer to the extent to which members' views on non-financial matters will be taken into account in preparing or revising the statement of investment principles,

but there is no provision for the SIP to mention non-financial matters. We think that, if non-financial matters are taken into account (when the Law Commission's two-leg test is satisfied), this should be stated in the SIP. We therefore suggest an extra provision is added to paragraph 3(b) of Regulation 2 of the 2005 Investment Regulations, requiring trustees to state their policy on the extent to which (if at all) non-financial matters are taken into account in the selection, retention and realisation of investments.

Q4. 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 not to require trustees to state a policy in relation to social impact investment. Given the limitation of common standards, low levels of education and awareness and misconception over expected returns identified by the Government's Independent Advisory Group on social impact investing[1], it would not be appropriate to introduce a requirement at this stage.

We share the Government's concern that confusion may arise from the fact that social impact investing is sometimes, but not always, compatible with achieving an appropriate return. We therefore suggest that consideration is given to deleting the reference to "social impact" in the definition of non-financial matters.

We do agree with Government that in many instances, social impact investment will be in members' best financial interest. Further we consider it to be in the public interest to grow social impact investing in the UK. As such, we support the Government's intention to monitor this market and to revisit at a later point to determine whether intervention would be beneficial.

We recognise that willingness to invest in impact investments may be limited by difficulty in proving financial equivalence and in measuring social outcomes. We believe the Government has a role to support and foster the emergence of best practice. To further encourage this, we propose the Government considers:

- Whether, in the first instance, it is appropriate to mandate public sector schemes to state their policy in relation to social impact investment.
- Directing encouragement at large and public sector schemes to consider how they might increase their impact investing activity.

Q5. 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 support the Government's proposal to require trustees to include their policy in relation to the stewardship of investments in the SIP. We recommend that the definition of "relevant persons" is

[1] See Independent Advisory Group's report 'Growing a culture of social impact investing in the UK' (Nov 2017)

extended to include regulators and policymakers, noting that these may be more effective parties to engage for issues that are systemic rather than company-specific (eg climate policy).

The requirement for schemes to have a stewardship policy is consistent with our response to the Financial Reporting Council's consultation on the future of the UK Stewardship Code earlier this year.

b) Do the draft regulations meet the policy intent?

We have no comments.

Q6. When trustees of relevant schemes produce their annual report, we propose 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?

Although we support the intent of implementation statements, we do not agree with the policy proposal as this would result in disproportionate costs being borne by trustees to prepare such a statement on an annual basis. We also note that members do not have a right to an annual report until and unless they request it, so in practice they tend only to be sent in full to members who request them, and in many schemes are never read.

b) Do the draft Regulations meet the policy intent?

We have no comments.

Q7: 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?

We do agree with the policy proposal, although we do not believe it should be mandatory for trustees to disclose these documents beyond members and the scheme's sponsoring employer. However, as noted in our response to Question 6, we do not support the proposal for an implementation statement.

b) Do the draft Regulations meet the policy intent?

We have no comments.

Q8. Do you have any comments on the business burdens and benefits, and wider non-monetised impacts we have estimated in the draft impact assessment?

We consider the impact assessment has not considered all the necessary inputs and the time and monetary costs of the proposals have been underestimated as a result. While time to read and digest the amended regulations has been factored in, we note that trustee time required to seek advice has not been allowed for. Further, we consider the impact assessment to underestimate the time needed to adequately understand and implement the requirements of the amended regulations, particularly as this is likely to be a new area of consideration for many trustees. We also do not think it realistic to assume that defined benefit schemes will simply adjust their triennial review cycle to accommodate the new requirements. Instead, we think it likely that many such schemes will carry out an additional review of their SIP, with future reviews continuing to be aligned with triennial actuarial valuation cycles. We would welcome analysis to show that the benefits of the proposed Regulations outweigh the costs.

We consider the 'numbers of members' threshold before requiring firms to comply with the requirements to be too low and encourage Government to consider increasing this from 100 to perhaps 1000. We consider the administrative burden of requiring schemes with fewer members than this, given the likelihood of their smaller asset size and extensive use of pooled investment products, would be disproportionate to the benefit achieved.

As identified in our response to Question two, we propose a phased approach allowing options to be explored in the market and giving schemes more than one year to revise their SIPs in respect of financially material risks. We believe it would be proportionate to require schemes largest in asset size to comply during the first phase, as we believe this is a reasonable indicator of the resources they will be able to dedicate to meeting the requirements.

We also encourage Government to consider options to alleviate possible burdens associated with implementation. Potential solutions may include a mechanism which allows funds to apply to the Pensions Regulator for an extension; or not requiring defined benefit schemes to revise their SIPs before their next scheduled triennial review.

Q9. Do you have any other comments on our policy proposals, or on the draft Regulations which seek to achieve them?

We have no further comments.

Q10. Do you agree that the 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 do not believe it should be mandatory for trustees to disclose these documents except to members and the scheme's sponsoring employer.

Q11. What evidence or views do you have of how well the other requirements in the SIP are working? What areas for further consideration and possible future change would you suggest?

We have no comments.

Should you want to discuss any of the points raised please contact Matthew Levine, Policy Manager (Matthew.Levine@actuaries.org.uk) in the first instance.

Yours sincerely,

Marjorie Ngwenya
Immediate Past President, Institute and Faculty of Actuaries