PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

16th July 2018

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Dear Sinead and Vicky,

PLSA RESPONSE: Consultation on clarifying and strengthening trustees' investment duties

We welcome the opportunity to feed in to your consultation on clarifying and strengthening trustees' investment duties. The PLSA is the voice for pensions and lifetime savings in the UK, representing over 1,300 pension schemes with just over £1 trillion in assets under management and over 400 supporting businesses – including asset managers, investment consultants and other service providers. Our purpose is to help everyone achieve a better income in retirement.

INTRODUCTION

Pension funds represent approximately 60% of the institutional investment money managed in the UK and have £2.2 trillion of assets under management. As owners of capital with long-term time horizons, both DB and DC pension funds are ideally placed both to take account of long-term risks such as climate change and act as stewards of their assets. In doing so, the value of scheme members' retirement savings can be protected and enhanced.

We welcome the government's commitment to supporting trustees to consider financially material environmental, social and governance (ESG) issues in their investment decision-making. We believe that doing so is a vital part of trustees' fiduciary duty but that the way the *Occupational Pension Schemes (Investment) Regulations 2005* (henceforth Investment Regulations, or Regulations) are currently drafted has caused confusion for trustees. We therefore support the proposed clarification within the Regulations of the difference between ethical considerations and financially material ESG considerations. We think that it is important that this change is reinforced by similar changes elsewhere in existing guidance.

We do not support the government's proposed changes in the area of scheme members' views. Although we recognise the government's work to make it clear that the proposals should not be seen as implying that scheme members' views take priority over trustees' role in investment decision-making, we do not believe the government's proposals in this area are either practical or purposeful. As currently presented, we think that the proposals in this area run the risk of causing greater confusion for trustees, raising false expectations amongst members and potentially reducing members' willingness to engage with their pension savings.

We support the government's proposals on broadening the language used to refer to a scheme's stewardship activities and believe it is important for any accompanying guidance to highlight the full spectrum of stewardship activities that can be undertaken by schemes. This should include explicit recognition of the fact that many smaller schemes will need to outsource their engagement work to their asset managers, and the implications this has for their overall approach to stewardship.

Although we support the government's proposals regarding scheme publication of the Statement of Investment Principles (SIP) online, we have significant concerns around the proposals to produce or publish a SIP implementation report. Given the lack of member interest in the pension communications they already receive, the significant challenges facing schemes in the current market and regulatory climate, and the wide range of areas a typical SIP usually covers, we do not believe that the (limited) benefits would balance the (significant, particularly for smaller schemes) costs of doing so.

Q1. We propose that the draft Regulations 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?
b) Do you agree that the draft Regulations meet the policy intent?

We agree that the timescales outlined in the consultation paper seem sensible. This is particularly the case given the FCA proposals on Independent Governance Committees (IGCs) are currently expected to be published in Q1 of 2019 and it makes sense for the timetable for regulatory changes to the environment for contract-based and trust-based pension schemes to be broadly similar.

We would also urge the government to consider and communicate to industry how the proposed changes to the investment regulations align with the new requirements on responsible investment placed upon schemes by the Institutions for Occupational Retirement Provision (IORP) II Directive (with particular reference to the requirements in 19(1)(b), 21(1), 25(2)(g), 30 and 41). The Directive must be implemented by 13 January 2019 – a relatively short timescale which is leading to some confusion amongst schemes and sponsors regarding whether the IORP II requirements will be imposed in addition to the new changes proposed in DWP's consultation or whether the government's proposals here will in fact comply with the relevant IORP II provisions.

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

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including, but not limited to, those resulting from environmental, social and governance considerations, including climate change.
a) Do you agree with the policy proposal?
b) Do the draft Regulations meet the policy intent?

We welcome the government's decision to clarify the difference between ethical considerations and financially material ESG considerations. There is a growing body of evidence[1] to demonstrate that ESG investment approaches achieve comparable or better financial returns than conventional investments. Although some schemes have long included ESG factors in their evaluation of material investment risks and opportunities, for others the journey is just beginning.

For instance, our 2017 research with Sustainalytics on *ESG Risk in Default Funds* found that many DC plan members investing in their scheme's default fund are significantly exposed to a number of ESG risks, including those related to human capital, business ethics, product safety and data privacy and security. This could have an impact on the investment performance of their savings and have adverse consequences for the income individuals receive in retirement.

Our members tell us that the way the current investment regulations are drafted with regard to ESG factors remains confusing. We ran a survey[2] of our pension fund members (including trustees, trustee Chairs and pension investment professionals) on this issue. 52% of members found the *current* law and regulatory guidance around their responsibilities for taking ESG factors into account in investment decisions either "not so clear" or "not at all clear".

We believe that the government's proposals that trustees should be required to state their policy on the evaluation of financially material considerations, including (but not limited to) environmental, social and governance factors, will be a helpful clarification. We think that the explicit separation between financially material ESG factors and ethical factors should support trustees in considering ESG factors and how this interacts with their fiduciary duties. The Law Commission and others have made clear that there is no legal barrier to trustees' consideration of financially material ESG factors; we believe that the proposed changes to the drafting will be useful in dispelling some of the confusion.

Accompanying guidance

This clarification in the investment regulations should be accompanied by clarification in other regulatory guidance and related papers to ensure consistency in messaging to trustees. For instance, The Pensions Regulator (TPR)'s guidance for DB schemes says: *"where you think*

[1] Examples of this include *Total Societal Impact: a new lens for strategy* (Boston Consulting Group, October 2017); *Can ESG add Alpha?* (MSCI, 2015); *Corporate Sustainability: First evidence on materiality* (Khan, Serafeim and Yoon, Harvard Business Review, 2015).
[2] The survey was run between 27th June and 16th July. 31 respondents took part, of which 25 were eligible.

environmental, social and governance (ESG) factors or ethical issues are financially material, you should take these into account". Although the emphasis is on the financial materiality of these issues, having "ethical" and "ESG" in the same sentence and context can lead to confusion. The Law Commission's own report on fiduciary duties occasionally uses the word "ethical" in place of "environmental" when describing "ESG" investment.

Although outside the scope of this consultation, we think it would be worthwhile in any guidance to clarify what "financially material considerations" are and give trustees a practical steer that this includes both ESG risks and also opportunities; ESG investment has been traditionally used as a risk-mitigation approach, but there is an evolving market for investing in ESG *opportunities* and we think any guidance should focus trustees' attention on the full breadth of ESG investment approaches.

The wording of the new Regulations

We welcome the removal of the ("if at all") wording in Regulation 2(3)(b)(vi) – we think as currently drafted, it potentially gave rise to trustees incorrectly assuming that ESG considerations were always 'optional' factors for consideration.

The PLSA believes that climate change poses a substantial risk to the business models of companies in nearly every sector, and the stability of the financial system. We produced our own report with Client Earth – *More Light, Less Heat* – in 2017 to support trustees in understanding how and why they should take climate risk into account in their investment decision-making.

We do not, however, think that it is helpful to pick out specific examples of 'E', 'S' or 'G' factors in the Regulations themselves, for the following reasons:

1) By specifically highlighting an example factor – such as climate change – trustees might infer that this is the 'most important' ESG factor to consider, when other factors such as resource depletion or human rights abuses might be more relevant to their portfolio. It also suggests that this example will always be material in all cases, whereas this may not be the case.

2) It is likely that new and urgent ESG risks will emerge over the coming years and the regulations themselves need to have sufficient flexibility to address this. We have already experienced the challenges which arise from the inclusion of specific words in the Investment Regulations and believe steps should be taken wherever possible to avoid replicating the situation.

We therefore do not believe that "climate change" should be included specifically in the drafting of the new Regulations as this could result in the Regulations being unintentionally prescriptive.

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

The issues covered by, and wording of, the Investment Regulations themselves have significant implications for schemes and the entire investment industry. A given change to these Regulations must be very carefully considered. From the initial drafting, any proposed changes should have a clear sense of purpose, be designed or proposed with an eye to avoiding confusion amongst scheme members (on an issue that many find difficult to understand) and demonstrate a clear understanding of the practical implications for the organisations and individuals affected.

We recognise and welcome the government's commitment to clearly highlighting and messaging that its proposals on taking account of scheme members' views should not challenge the primacy of trustees' decision-making on investment issues. Members are not – nor should they be expected to be – investment experts and trustees have a duty to invest in members' best interests, even if doing so runs counter to the strongly-held beliefs of certain individuals.

Despite this precaution, however, we do not believe that the government's proposals in this area are either practical or purposeful or sufficiently take account of the differing natures of DB and DC schemes.

The differing nature of investment risk – DB and DC schemes

For DC schemes in particular – where the nature of the investment risk is that it is borne by the member – it is good practice to invest with an eye to member views. One tangible way in which some DC schemes demonstrate that they are doing so is to offer members 'self-select' funds with particular ethical or social impact attributes[3]. We also think that more could be done to communicate with scheme members about investment strategy through, for instance, online publication of schemes' SIPs (please see our response to Question 7).

The investment power of a DB scheme is instead to invest for the provision of a defined level of benefits, with the risks generally underwritten by the scheme's sponsoring employer. Implying that trustees may want to consider canvassing member opinion on DB investment may obscure the need for DB scheme trustees to consider the important view of the employer, including its appetite and ability to bear the risk of any potential investment downside.

Practical Challenges

[3] This is contrast to those schemes which include ESG considerations as part of their broader approach to risk-mitigation as part of their *default* investment strategy.

Whilst we believe there is merit in encouraging schemes to think about how and when they should consider members' views on investment issues, we have significant concerns about the practical implications of the government's proposals for both DC and (particularly) DB schemes in this area. Issues that we believe may end up causing greater confusion amongst both trustees and members and ultimately undermine the impact of the other beneficial steps being taken to clarify the Regulations for trustees.

1) Confusion between ESG and ethical issues

   As stated above, we welcome the government's intention to clarify the distinction between consideration of ESG and ethical issues and how these interact with trustees' fiduciary duty. We are concerned that amending the regulations to include explicit reference to a scheme's approach to considering member views may confuse trustees – who have limited time to consider a broad variety of issues at each meeting – and they may be side-tracked into focusing on member views (which may differ widely) on non-financial matters instead of material ESG considerations.

2) Member expectations

   We welcome the government's commitment to signalling in this consultation – and the surrounding press – that trustees are never required to act on any particular concern and retain control of investment decisions. However, there is significant risk of misinterpretation and false expectations being raised among pension scheme members that their views are either likely to be or must be taken into account.

   It is the case that many schemes will quite legitimately (and in line with their fiduciary duties) not take member views into account in their investment decisions. It is possible that a scheme member who, in light of the proposed changes to the new regulations, expresses views on a certain issue but then does not see action undertaken by its scheme will feel de-motivated and be less encouraged to engage with their pension savings and options.

3) Limited legal and practical relevance of non-financial matters

   In (legal) reality, the circumstances under which a scheme can even consider taking views into account remain very narrow, needing to meet the two-part test outlined by the government in its paper. Legally, trustees should be extremely cautious about taking non-financial matters into account in any circumstances other than as a "tie-breaker" between two financially equal choices. It also remains difficult for trustees to determine the risks of financial detriment – and whether or not such financial detriment is 'significant'.

   Given the limited circumstances under which members' views can be taken into account, we are concerned that the government's proposals in this area give undue and disproportionate prominence to the consideration of non-financial matters.

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4) Areas which require significant further exploration

We believe that there are many important practical questions raised by the proposed changes to regulations in this area which have not been sufficiently addressed and for which, given the proposed timetable for the regulations, there remains insufficient time to do so.

i) The Law Commission has stated that there is no threshold member response rate which must be met for trustees to decide whether to act on the results of a member survey. The majority of savers' actions in regards to their pensions are characterised by inertia – of course, this is the driving force behind the success of auto-enrolment. It is possible to envisage a scenario where a tiny demographic with particular views on one issue responds to a survey or makes their views known in another way but the majority of members do not respond at all.

ii) There would need to be agreed definitions and standardisation of how ethical and other non-financial issues should be framed for member surveys and other ways in which members' views are canvassed. This is vital to avoid the use of 'leading' framing of questions and ensure consistency of terminology across schemes and clarity for members.

iii) It is unclear what would happen when a non-financial matter is believed by trustees to be held by members, is taken into account and acted upon, but this stance on this issue becomes financially material and detrimental to returns. How would such a situation be communicated to members and what impact would this have on member engagement?

Given the significant challenges in terms of practicality and purpose we've outlined above, we do not believe that changes should be introduced into legislation on this issue. We instead think that further guidance and communications from TPR should be given regarding what constitutes best practice – for schemes of all sizes – on thinking about when to canvass member views. Further consideration should then be given to the desirability of any regulatory requirements once evidence has been gathered to inform the creation of practical and proportionate steps which address the challenges we have highlighted above.

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?

As long-term investors with significant amounts of capital under management, pension funds are well-placed to invest in a way which has a positive impact on the society in which scheme members live. The PLSA supports the government's commitment to social impact investment.

We have played an active role in the work of the Advisory Group on *Growing a Culture of Social Impact Investing* as well as the follow-on Steering Group. Part of our work has included the publication of a Made Simple Guide on impact investment to raise awareness amongst trustees of this topic.

However, we agree with the government that at the present time, trustees should not be required to state a policy in relation to social impact investment. The market (and marketing) for such products is still evolving and the definition of what constitutes an impact investment remains in flux. While some products set out to achieve a measurable social objective alongside financial outperformance, the traditional impact investment approach has often involved a trade-off between achieving a social objective and a financial one.

As the current proposals constitute an effective way of clarifying the different requirements for trustee consideration of financially material ESG matters and non-material ESG issues, it would be counter-productive to require trustees to state a policy on impact investment. We think the government is right to acknowledge that requiring trustees to do so on social impact investment specifically may lead to greater confusion. At this time, we believe that the government is taking the correct approach to social impact investment in the regulations, though we hope that will change as the market continues to evolve.

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?
b. Do the draft Regulations meet the policy intent?

We support the government's proposals to clarify the investment regulations in this area. The PLSA strongly believes that pension schemes should undertake stewardship – in proportion to their size and capability. We believe that effective stewardship is a fundamental part of trustees' fiduciary duties and vital in helping schemes protect value and maximise long-term returns for scheme members.

We agree that the investment regulations as currently drafted could be construed to mean that voting is the most important aspect of stewardship – and that trustees may infer that this is all that they need to consider when thinking about stewardship, as well as limiting consideration to asset classes with voting rights. We welcome the government's proposals to explicitly broaden this to include engagement.

However, we believe that there remains a great deal of confusion amongst trustees, including those of smaller schemes, regarding how they should consider and undertake stewardship. We understand that where trustees are invested in pooled funds, or passively, there is still often a perception that it is too costly or impossible to undertake any kind of stewardship of their investments. We believe that the government should seek to address this by acknowledging (and signposting) the full range of stewardship activities that schemes can undertake in any

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accompanying guidance[4]. This should include recognition that for many smaller schemes, a proportionate approach to stewardship will be to outsource its implementation to their asset manager – and that it can be more challenging for smaller schemes to wield influence over the precise nature of their manager's stewardship activities.

Ideally any guidance would make reference to the following in its spectrum of stewardship activities:

- Active and direct engagement with investee companies either individually (this is likely only to be possible for larger schemes with an in-house team), or collaboratively through forums such as the PLSA and the Investor Forum

- Where possible, collaborative engagement and interaction with other schemes which are invested in the same pooled fund

- Asking questions of your passive/pooled fund manager/product provider and becoming familiar with managers' stewardship processes (as suggested in TPR's guidance to DC trustees) and then – working with a scheme's advisers – using this data to inform manager selection and scrutiny

There should also be explicit acknowledgment that schemes' resources and capacity for stewardship will vary, from primarily outsourcing this activity to asset managers to undertaking stewardship in-house. Accompanying guidance should also reassure schemes that the intention is not to insist schemes undertake direct engagement themselves, but that they should instead consider which stewardship approach is best suited to their size, approach and objectives.

Finally, we would urge government and regulators to produce guidance which recognises that different engagement approaches will be suited to different asset classes. For instance, the most effective stewardship approach for certain large infrastructure investments may be to undertake significant due diligence prior to the initial investment.

Q6: 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?
b) Do the draft Regulations meet the policy intent?

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[4] The PLSA produces its own guidance on how stewardship can be undertaken by schemes with varying levels of resource. This guidance can be found on our website on our 'Stewardship Central' webpage.

And

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

We agree that it is important for trustees, employers (where relevant) and their advisers to take the time to consider and tailor the SIP to the needs and objectives of the specific scheme. We also believe it is sensible for schemes, members and civil society to have easy access to a scheme's SIP: this would allow members and researchers to scrutinise and compare SIPs and give schemes a better idea of industry best practice. We therefore support the government's proposals that schemes publish the SIP online as we believe the costs of doing so seem proportionate to the benefits.

However, we do not support the publication of a SIP implementation report because the possible benefits of doing so are unproven and the costs and practical issues involved are substantial. It is particularly important that the impact of any extra reporting requirements are carefully considered at this time of significant legislative and regulatory change in the sector, where schemes are grappling with a series of substantial challenges including (but by no means limited to): the end of the market cycle; Brexit; member engagement (both DB and DC but particularly the latter); the current CMA investigation into the investment consultancy sector; and rising longevity. On the publication of the member views' statement specifically, 88% of the fund members who responded to our survey thought that the requirements would be "very" or "quite" burdensome.

Producing a SIP implementation report would be unwieldy and extremely costly for schemes; a typical SIP covers a large number of areas including such as fund design, risk management, manager selection and review, and stewardship. Assessing performance in each of these areas, drafting the report (including work to make it as easy to comprehend as possible) etc. would be a cumbersome and costly exercise for schemes – and likely to be disproportionately costly for smaller schemes. With so few scheme members engaging with even the information they are given now and with little evidence of member demand for further information on such issues, we do not believe that the likely gains from improvements in transparency and accountability are worth the significant costs involved in producing an implementation report.

It is also the case that schemes do currently undertake a significant level of reporting, including the DC Chair's Statement and the annual member benefits statement, the precise requirements for which are continually being amended and added to. We urge the government and regulators to carefully consider how all these reporting requirements are aligned to avoid duplication.

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However, given that current regulations already require trustees to have a SIP, we believe that it should be relatively low-cost to publish this online. We believe that a proportionate approach to greater accountability would consist of publishing a scheme's SIP in an obvious and accessible place on its website (or linking to the provider's website).

We do not support signposting to this information in the annual benefit statement as we believe that the statement is a vital tool for member engagement and should therefore be kept as simple and concise as possible[5].

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?

N/A

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

N/A

Q10: 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?

N/A

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 think that the current balance between detail and high-level information is broadly right.

We believe it might be beneficial for DWP to consider in the future whether the SIP requirements more generally should be split for DB and DC schemes – this consultation alone has illustrated the depth of the differences between these arrangements. It might be worthwhile considering whether to allow schemes with multiple sections to operate different SIPs for each section.

[5] The PLSA is closely involved in the project being led by Ruston Smith to develop a simpler annual pension statement. This project aims to standardise the wording, format and assumptions used in annual pensions statements and we believe it will make them easier for savers to understand. A simpler statement will therefore necessarily have to focus on the key information about contributions, pot size and likely retirement income only.

If the SIP is to be published online (which we support) we would not support asking trustees to insert further detail: it is already relatively complicated for members to follow.

We hope that the above is helpful. Should you like any further clarification I hope you will not hesitate to get in touch.

Caroline Escott
Policy Lead: Investment and Defined Benefit

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