Response to the DWP Consultation on Clarifying Trustee Investment Duties; by

THE TRANSPARENCY TASK FORCE

July 16th 2018.

About the Transparency Task Force

The Transparency Task Force (TTF) is the collaborative, campaigning community, dedicated to driving up levels of transparency in financial services, right around the world. We believe that higher levels of transparency are a pre-requisite for fairer, safer and more efficient markets that will deliver better value for money and better outcomes to the consumer.

Furthermore, because of the correlation between transparency, truthfulness and trustworthiness, the TTF expects its work will help to repair the self-inflicted reputational damage the sector has suffered for decades.

For further information about the TTF see:

www.transparencytaskforce.org

About TTF's Team PISCES

The TTF seeks to operate in a collaborative, collegiate and consensus-building way; focusing on solutions, not blame. It has over 300 volunteers organised into 13 teams. Each team is working on one or more campaign objectives.

Team PISCES is for those that like the idea of the world's capital markets becoming a 'force for good' and at worst want the financial ecosystem to 'do no harm'.

Why is the team called PISCES?

P is for Purpose;

I is for Impact Investing;

S is for Sustainability;

C is for Corporate Social Responsibility;

E is for Environment, Social and Governance;

S is for Socially Responsible Investing.

As such, the DWP's consultation on Clarifying Trustees Investment duties has been of great interest to members of Team PISCES, hence this response.

The contributors to this response were, in no particular order:

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- Bethan Livesey, ShareAction
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Note that not all the participants agree with every point we make in this response; the views expressed represent the general consensus that has been formed for the purpose of this response.

Introduction

As per our response to the EU Commission High Level Expert Group (HLEG) response (which can be downloaded at this web page: https://www.transparencytaskforce.org/teams-of-volunteers/team-pisces/), The Transparency Task Force ('TTF'), sees an urgent need to align the financial system with societal goals more broadly (e.g. Sustainable Development Goals) to create a more purposeful capital model.

We therefore welcome Her Majesty's Government's response to the Law Commission recommendations ('the Government response') and the related consultation. We see this is a critically important step to accelerate the pace of progressive change in the UK pensions industry.

We have previously stated that we would like to see Environmental, Social and Governance (ESG) factors explicitly included in investment governance, valuation models, buy/sell side analysis and business sustainability ratings from ratings agencies which explicitly consider longer term risks. We believe demand is driven significantly by asset owners and so the proposed changes should help to unleash market forces to improve the availability of comparable information on assets and the availability of longer term, holistic risk assessments of those assets. This will in turn encourage proactive positive behaviours among all participants, to integrate ESG more rapidly and coherently.

From a risk perspective, we believe it is an imperative to call out climate change as a particular example of a material risk. A failure to mitigate climate change will significantly increase the challenge of dealing with almost all of the other Sustainable Development Goals due to the interconnectedness of risks and as many recognise we are now in a perilous situation with regards to emissions, pollutants and global warming. Therefore current mitigating actions (even if adhered) may simply not go far enough to reduce the residual climate risk or change our trajectory towards higher temperature scenarios. Therefore trustees cannot recuse their responsibility on grounds of expected political or regulatory actions.

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?

Yes, we agree with the proposals. The timeframe should be readily achievable, given that Schemes with more than 100 members will already have a Statement of Investment Principles (SIP)and smaller Schemes will require no further action (Defined Benefit) or will only have to update their default fund to take account of financially material considerations (Defined Contribution).

This is important because, given the nature of some of the risks we are facing, such as climate change, there is a degree of urgency required. Further, as many have commented, there is a need to align governance activity with the timeframes and broader objectives of beneficiaries. However without the integration of climate risk, and investment processes, then we will always face resistance from participants who prioritise short-term profits over long term outcomes. With such competing forces left unchecked then achieving optimum Stewardship will remain elusive and climate risk uncontrolled. The question in the Government response to savers: "What world do you want to retire into and pass on to future generations?", is an extremely important broader point that can be missing from discussions that are focused on short term financial outcome. However, it should not be overlooked that the value of pensions for people working and saving *now* is at risk if climate change is not taken into account by schemes. As a near-term example, a recent survey by UKSIF showed a strong consensus that oil majors could be negatively re-valued within as near a timeframe as 2 years[1]. Such an event would have a dramatic effect on pension investments given typical portfolios and may be the first of many such events if climate change risk is not addressed by schemes now.

Nonetheless, we recognise that climate change and other ESG risks are one of a basket of many risk and opportunities that schemes need to consider. Schemes that have carried out analysis of some of these risks consider not only the downside risk but also the upside investment opportunity and this would be a point worth referencing. Analysis in this area continues to develop; helping to inform trustee policy, whilst trustees are urged not to abstain from action simply on grounds of insufficient financial data; when non-traditional data is abundant, clear, compelling and verifiable. Trustees should challenge their advisers and/or enlist specialist firms to assist data availability.

We note that funds in the Local Government Pension Scheme were given less time to cover similar policies in their new investment statements (approximately 5 months).

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

The proposals meet the policy intent, in terms of accelerating the pace of progressive change in the UK trust based pension market and dealing with the issue of trustee confusion around these issues by focussing on responsibilities and expectations of structured delivery.

However the proposals do not ensure that the goals of financial markets are aligned with SDGs, however, they are an important step in requiring trustees to think more broadly.

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?

[1] http://uksif.org/wp-content/uploads/2018/04/UKSIF-Not-Long-Now-Survey-report-2018.pdf

Yes, we agree with the proposal. The act of documenting a SIP should encourage trustees and their advisors to carefully consider these issues, which may arise over a longer time frame than is typically considered. This could be achieved through; a mandatory standing item at trust meetings, the expansion of the SIP itself (as proposed) or an annex policy of responsible investing. For example, before documenting a position on climate change, trustees will first need knowledge to understand the risk, apply the risk to assess how it impacts their scheme and understand materiality to then decide what action may be appropriate both in terms of scale and magnitude. For example, divesting from assets completely versus rotating from poor ESG scoring assets to those with higher ESG scores (known as tilting). This then allows for the provision of actions and targets by which trustees, and their advisers, can measure and be measured on progress through an implementation report. We note that the PLSA has set out guidance for trustees on a framework for how to approach climate change[2], which is helpful. Further guidance on other ESG considerations would be welcome.

b) Do the draft Regulations meet the policy intent?

Yes, as it will clarify for trustees that ESG considerations can be (and often are) financially material considerations. There is no definition of "financially material" given, however, and it may be that for less well-resourced schemes guidance around the format of the SIP and how to set the bar for financial materiality would be appreciated. Some form of standardisation may be helpful for these schemes such as those identified by SASB Organisation. Although we note that the courts have not tended to question trustees' decisions on balancing risk and return.

Mentioning climate change explicitly will also help trustees relate that to ESG, but in order to avoid duplication in wording and to make them think more broadly, "including climate change" could be changed to "such as climate change".

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 principle, we support the proposal (because we think it is an important development in clarifying the law), but we do have some concerns with it in its current form and how it may be interpreted by trustees who are concerned about its scope. We agree with paras 19 to 35 of the consultation paper which make it clear that trustees retain complete discretion on investment and do not have to act on the basis of members' views. The Law Commission has also been clear that trustees have a lot of flexibility when it comes to deciding what to do with information about members' views e.g. trustees do not need to become embroiled in disputes about what members' think or be beholden to a vocal minority. This does not detract nor discourage a scheme canvassing, educating and engaging with its members on

[2] https://www.plsa.co.uk/Policy-and-Research-Document-library-More-light-less-heat

matters like climate change but the fiduciary responsibility is clear and should not be confused.

We envisage greater problems for DB schemes, as investment strategies can be more complex, and can affect (or be affected by) the funding strategy and the Employer covenant. There are also often specialist financial instruments, such as derivatives and hedging, which are unlikely to be understood by the members. We note ESG analysis in many of these asset classes remain embryonic at best and irrelevant in some cases.

We therefore feel that the wording in the statement could still cause difficulties and confusion, both to the members and the Trustees, and so we would suggest that the drafting could be clarified by requiring trustees to state:

1. what they have (or have not) done to find out members' views on non-traditional matters; and
2. how any information they have obtained about members' views will (or will not) be taken into account in preparing or revising the SIP.

Separate guidance should also be given to trustees of DB and DC schemes, for the reasons stated above.

b) Do the draft Regulations meet the policy intent?

Generally yes in that it may well encourage members to engage more, which is especially important for DC schemes where the members will have their own individual pots of money. A number of DC stakeholders have produced short, educational and dare we say it, engaging videos on this topic. For example:

- Quietroom – Pension Money: where it's invested and the good it does
- Aviva – Do you know how your pension is invested?
- Shareaction – Pensions for the Next Generation

These are by no means comprehensive or exhaustive; they are not meant to be, but we feel they demonstrate that it is not impossible to engage members in a different and positive way on their savings.

However, as stated above, we can see challenges with incorporating member views, especially ones which are based on ethical preferences, as individuals generally have different ethical preferences and so, again, some care will be needed in assessing members' views and the communication of how these are taken into account.

As also intimated earlier, we can see the need for differences between DC and DB schemes in this area.

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 think HMG could go further here. We start from a position that all investments have impact; good and/or bad, but we simply don't measure many of them currently. One way of thinking about impact is to group investments into 4 types with regard to impact:

i. **Social impact investments.**
Investments with a specific purpose, for example, a renewable energy installation or affordable housing, university and health projects, which require funding and provide a return to investors. These may be funded through publicly listed companies but more likely to be funded in the non-rated debt market by private markets and institutional investors. There may be different risk/return characteristics for these investments and traditional impact investors will take these into account along with the impact of the investment, thus there are 3 key metrics for investment decisions – risk, return **and** impact. Risk will include issuer risk, development and construction risk, lender risk and liquidity risk. More complex financial risks may also arise from the more complex capital raising models including mezzanine lending.

ii. **Investments in companies with positive impact.**
For example, investment funds which invest into companies which provide solutions to the SDGs and report on performance against SDGs as well as financial returns. See Impax Asset Management or Baillie-Gifford's Positive Change Fund for examples of this. These strategies may be more likely to invest in small to mid-cap companies, although do not do so exclusively. These strategies generally aim to outperform the market, which social impact investments may not seek to. Investing in small to mid-cap companies are typically less liquid, have smaller balance sheets, more volatile cash flows and earnings and more subject to higher stock specific risk, which may also increase the risk profile of an investment portfolio and should therefore be considered by trustees and investors.

iii. **Impact through stewardship and engagement.**
It is unlikely that either of the above 2 strategies will hold significant large cap companies, which also inherently may change the risk profile of an investment portfolio. For example, it is hard to see many extractive company stocks in a positive impact fund. This is where stewardship and engagement activities become critical. For example, HSBC's and LGIM's stewardship and engagement activities through its Future World Fund, including 'naming and shaming' poor performers, may well be successful in encouraging large companies to change course on climate change.

iv. **Broad ESG or Sustainable (including Climate-related) Investments**
Investments that explicitly consider the sustainability of returns of their investee companies, considering Environment, Social and Governance characteristics. Such investments would aim to reduce negative impact to the environment or social communities in which investee companies operate. Such strategies can include (but are not limited to) positive screening to invest in companies that score higher on ESG grounds but would often be avoided by strategies that apply negative screen or

invest in positive impact companies. Note that many strategies today incorporate ESG into their investment decisions and risk management, yet won't explicitly define their strategies as ESG or SRI so care must be taken to ensure that pro-ESG ad pro-SRI funds that do not explicitly label themselves in that way should not be overlooked.

All of the above investment activities clearly have impact and/or aim to reduce negative impact, and we suggest they are all important.

But the significant investment by pension schemes into passives suggest that stewardship and engagement will continue to be an important theme in driving good corporate outcomes.

We can also see the attraction of the investment strategies outlined in (ii) in terms of diversified returns, outperformance and also good societal outcomes and member interest.

In order to appropriately acknowledge these various investment activities under a common umbrella, we would advocate that they be reflected in the SIP or in an annex policy of responsible investing (see the response to Q2 a) above) rather than requiring a specific Social Impact Policy.

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?

Yes, we agree with this policy proposal. As stated in our response to question 4, stewardship and engagement can be very effective in driving corporate change and we believe pension schemes, as responsible owners of companies, should have a clear policy on stewardship, which their investment managers should enact for them. Stewardship could be linked to the SIP or within an annex policy of responsible investing, to the SIP.

b) Do the draft regulations meet the policy intent?

Yes albeit we believe that policy may require further attention in response to changes to climate risk data.

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?

Yes, we agree with this policy proposal, although the inclusion of members' views in the annual report will be subject to the concerns expressed in our response to Q3.

It is one thing to write down a policy, another to report on its implementation. We believe the publication of an implementation report, signed by the Chair of Trustees, is an important step for the trustees, the regulators and the members who read the report. We note potential resource challenges for smaller schemes, however, and again we wonder if some kind of standardised format may be helpful in practical terms. This proposal should prevent relevant schemes from disclosing only vague, high-level statements on their approach to ESG factors but instead set out clear policies and scrutinise implementation.

b) Do the draft regulations meet the policy intent?

Yes albeit further work will likely be required in future.

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?

Yes, we agree with this policy proposal, although the inclusion of members' views online will be subject to the concerns expressed in our response to Q3.

Acknowledging the possible strain on resources of smaller schemes, we nonetheless cannot see much downside here, certainly for DC schemes. Note that we have interpreted Q7 as seeking comment in relation to DC schemes and not DB schemes. The potential complexity and other factors mentioned in Q3 regarding the investment strategy for DB schemes may cause some problems of understanding for the members, but on balance we think there are likely to be more advantages than disadvantages. In general, we see this as simply enhanced transparency, of which we are very supportive.

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?

There may be a case for a scaled implementation approach starting with larger schemes that have economies of scale advantage. Support frameworks such as an ESG starter kit for trustees would aid smaller schemes, recognising that many small schemes do not have professional trustees. It is hoped that good practice will develop sufficiently rapidly for smaller schemes to be encouraged to engage more with their investments. Further guidance around definitions and materiality would also reduce implementation overheads. Guidance on how to manage the responses to members would also be helpful. For example, if it is decided that members should be asked for their views and preferences, the members will expect to see publication of these. This will not always be possible or feasible, for the reasons outlined in Q3, and therefore trustees are going to need to explain why they might not be in a position to meet all members' individual questions and expectations. Guidance on handling this would be very helpful and be beneficial to members as well.

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

Ensure that sustainable, Socially Responsible Investing (SRI)and ESG investments are not excluded from the universe through limited 'definitions' or 'regulatory constraints', because they too will inherently benefit society, the environment and provide return potential. Also the treatment of such investments for; matching asset, capital charge and Liability Driven Investing (LDI) requires significant overhaul to enable real change. Typically most DB based strategies do not factor ESG risks into cash flow assumptions. If we exclude them, or limit the requirements to only 'impact' investments, then we are at risk of alienating a large arsenal of assets that could also 'do good' and this will, in turn, reduce choices and ultimately benefits for trustees and members.

The duty of trustees is to pay the correct benefits to the correct persons at the correct time, and the trustees' investment strategy should accordingly take into account long term trends and sustainability of investments in order to discharge this duty over the extended time horizon of a pension scheme. Relevant information may be non-traditional in nature and be comprised of ESG factors where relevant to future financial performance. It is clear that changes in these factors, which are not otherwise priced into the market, can have an unpredictable, rapid, and dramatic impact on corporate success.

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?

Generally yes, subject to our concerns about the inclusion of members' views expressed in our response to Q3. If it is decided that members should be asked for their views and preferences then, as stated in Q8, guidance to trustees on how to respond to individual members about meeting their expectations and preferences, would be very welcome and should be included. For example, there may be a number of views received which, for good reason, cannot be published and some guidance on how trustees should respond to such views would be very helpful, as it will be important in the engagement process with members to go back to them about why they are being excluded.

Furthermore, we would suggest that clarification be provided on whether the actual views of members will need to published as this point may lead to confusion, inconsistency and even a reluctance for people to share views.

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?

Transparency of all fees and any possible incentivisation to managers and consultants, remains as yet not achieved but we recognise the efforts being made in this area. For example the cost to implement Green Finance should be subject to cost transparency but not used to impede needed change in respect to climate risk; for example if participants argue against the cost of implementation of ESG.