THE INVESTMENT ASSOCIATION
INVESTMENT MATTERS

RESPONSE TO DWP CONSULTATION ON CLARIFYING AND STRENGTHENING TRUSTEES INVESTMENT DUTIES

16 JULY 2018

ABOUT THE INVESTMENT ASSOCIATION

The Investment Association is the trade body that represents UK investment managers, whose 240 members collectively manage over £6.9 trillion on behalf of clients.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks & shares ISAs.

The UK is the second largest investment management centre in the world and manages 36% of European assets. IA members hold in aggregate, 34% of UK publicly listed companies.

More information can be viewed on our website.

EXECUTIVE SUMMARY

- Stewardship and long-term investment are essential components of a sustainable economy. We are therefore supportive of the proposals to clarify and strengthen trustees' investment duties as they will stimulate greater demand for stewardship and the management of financially material Environmental Social and Governance (ESG) risks factors, contributing to a better market for long-term investment. Behavioural change will not result from legislative change alone however; trustees will need support in understanding and implementing these duties.
- Stewardship is about more than voting. Asset Managers use a variety of engagement strategies and engage on a wide range of relevant topics including strategy, performance, board composition, diversity, pay and incentives, capital management, culture, human capital and audit and accounting. It is important that while seeking to create client demand and define policies in relation to stewardship we don't inadvertently restrict the potential for stewardship activity. We recommend amending the proposed regulations to clarify that stewardship is not limited to a narrow range of issues or methods of engagement.
- By encouraging trustees to better understand the views of their membership they will be able to make more informed decisions about their investment principles. Engagement with members on ESG issues could also generate greater member interest in their pension. Some pension schemes, and larger schemes that service multiple employers in particular, may find it challenging to give appropriate consideration to the views of a diverse membership; explaining how they take

member views into account, without inadvertently disenfranchising some members will be a communication challenge.

- It is our members' role to help their clients, the assets owners, to achieve their goals and objectives. By supporting their clients to achieve these goals our members contribute to economic growth through the efficient allocation of capital. These will primarily be financial objectives, but can also be non-financial. The IA therefore supports initiatives to promote and develop social impact investment, so that our industry can better service both the financial and non-financial investment objectives of our clients. The IA will continue to work to develop the market for sustainability and responsible investment so that trustees can have better confidence in allocating capital to this market. In particular we will continue to work to develop standard definitions for sustainability and responsible investment, and improve disclosures by assets managers including in relation to non-financial outcomes.

- We agree with the proposal not to include a requirement in regulations for trustees to state a policy in relation to social impact investment at this time, but would expect this to be kept under review as this market continues to evolve and as trustees' understanding of their members' views develop.

- The IA will also continue to work to develop a better market for stewardship, by improving and drawing attention to the public disclosure of stewardship activities by investment managers. By being more open about how they conduct stewardship, asset managers can help to create awareness of the value of stewardship, and help pension schemes to identify the different approaches of different asset managers. A key part of this is developing the Stewardship Reporting Framework, which helps asset managers to report on their stewardship activities in a consistent way through a mix of summary statistics and case studies on both engagement and voting.

RESPONSES TO QUESTIONS

1. **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?**

One year after the regulations are laid should provide sufficient time for pension schemes to make the relevant changes to their Statement of Investment Principles and default strategy (for DC schemes) required by the new legislation and to provide a statement on how members' views have been taken into account. One year after implementation of the new SIP should also be sufficient time for trustees to produce an implementation report.

Regulatory guidance for trustees on DB investment and DC Investment Governance provided by the Pensions Regulator will need to be updated to support compliance; this should be updated in a timely fashion to enhance Trustees' understanding of their duties under the new regulations.

As trustees revise their SIP, many will consider for the first time their views on the materiality of ESG risks and stewardship responsibilities and others may develop their policies on specific controversial investments in response to better understanding member views. This may impact on the contractual relationship between pension funds and their asset managers, as trustees will want to ensure that any changes to their policies is reflected in their investment mandates and asset managers are meeting their needs.

b. Do you agree that the draft regulations meet the policy intent?

N/A – it is only relevant for us to comment on the policy proposals for this 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, those resulting from environmental, social and governance considerations, including climate change.**
    a. **Do you agree with the policy proposal?**

Yes, as long term investors it is essential that pension schemes direct their asset managers to effectively consider and manage all financially material factors that will impact on the long term risk adjusted returns to their investments. It is appropriate therefore for Government to clarify that pension schemes should consider all financially material factors in their investment principles. It is also appropriate for the Government to specify that those considerations should include (but should not be limited to) ESG considerations including climate change, especially in the face of evidence cited in the consultation that is not widely understood by trustees that these can be relevant financially material (rather than only ethical or values-driven) considerations. Behavioural change will not result from legislative change alone however; trustees will need support in understanding and implementing these duties.

In March 2016, the Investment Association published its Productivity Action Plan[1] to help boost productivity in the UK through long-term investment and enhanced investor stewardship. The report identified a risk that the Statement of investment principles (SIP) and investment mandate, which governs the relationship between asset owners and asset managers, inadvertently embeds a short-term approach in the investment chain. This is a result of the manner and frequency of how performance is assessed through the contractual relationship between asset manager and asset owner and insufficient signalling of the need for a long-term approach governed by strong stewardship through the SIP and mandate. A key recommendation from the Productivity Action Plan is to simplify behavioural incentives within the investment chain, and ensure that the agreed incentives and governance of the investment chain ensure a clear alignment with clients' long-term investment objectives.

The enhanced focus therefore on long-term, financially material factors, including ESG (including Climate change), in pension schemes statement of investment principles is therefore a welcome step ensuring clear alignment of long-term factors in the investment chain. This will signal greater demand for the consideration of these factors by asset managers.

Our members believe that the sound management of ESG risks by a company can positively affect the companies' ability to deliver sustainable value creation for its shareholders. Our members therefore consider ESG analysis of investee companies to be a part and parcel of good stewardship, so that can deliver long term value for their clients. As stewards, not only do investment managers conduct ESG analysis to inform investment decisions, but also, through engagement, help the companies' efforts to better manage these risks and opportunities and transition to more sustainable practices. They want the companies they invest in on behalf of asset owners to remain a sustainable long-term investment proposition, and this will include (amongst other ESG factors) considering how they are managing the low-carbon transition and human capital development where they are relevant to their business and its long-term sustainability. Good stewardship doesn't mean focusing on all ESG risk factors all of the time, but involves making an assessment and conducting appropriate engagement on material ESG risks and opportunities to the long-term sustainability of the company under consideration at the relevant time.

The Investment Association is working to promote the case for ESG integration into investment processes and to help our members develop best practice across liquid and illiquid assets. Whilst a significant number of firms in the asset management industry are already embedding ESG considerations into the fabric of their investment processes, there is clearly

[1] Productivity Action Plan, the Investment Association, March 2016: https://www.theinvestmentassociation.org/assets/components/ima_filesecurity/secure.php?f=press/2016/20160322-supportingukproductivity.pdf

more to do in order to promote sustainable finance, including bringing consistency of language and disclosures; this will aid asset owners in the selection of managers that are aligned with their principles. Greater demand for this work from asset owners will help the investment industry to focus on these important initiatives and these new regulations are an important step in boosting this demand.

b. Do the draft regulations meet the policy intent?

N/A – it is only relevant for us to comment on the policy proposals for this 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 our proposals?

Steps to enhance scheme members' - and consumers' more generally - understanding of the relationship between their pension scheme, the investment industry and the companies asset managers invest in on their behalf are important for promoting trust and confidence in the pension system and encouraging people to save for their retirement. This becomes even more important as we consider how best to engage the new generation of automatic enrolment savers.

Both the transition to DC pensions and the pension freedoms bring a significant element of control for individual savers. Engagement on contribution rates and, later in life, on how a DC pension is to be accessed, is therefore especially important for DC scheme members. While some members may be confident in picking their own investment strategies the experience of automatic enrolment to date is that the majority of member money is invested in default strategies. While we shouldn't expect DC scheme members to suddenly engage with the investment strategy as a result of the proposed regulations, there is a possibility that ESG issues could generate greater member interest in their pension and encourage engagement in the areas highlighted above over the long term.

Through the investment of their money, all pension scheme members have a stake in the way that the scheme conducts investment activity. We agree therefore that DC scheme investment policies should be formulated having at least understood scheme member views with respect to the items under consideration in the policy and the requirement for schemes to make a statement on the extent to which they have taken these views into consideration.

Since the proposals do not direct trustees to invest in accordance with member views but only to consider their views, it is important that this process is managed carefully in order to avoid any further disenfranchisement of scheme members from the investment process. Regulatory guidance will be especially helpful to support trustees in formally demonstrating how they take account of member views, as how this exercise is conducted will be essential to engaging scheme members with pension saving more generally. Larger schemes that service multiple employers may find it challenging in particular to give appropriate consideration to the views of a diverse membership; explaining how they do so will be a communication challenge.

By encouraging trustees to better understand the views of their membership the proposals will contribute to creating a better market for stewardship. As end clients and the public better understand what role stewardship plays in promoting good member outcomes, there should be greater demand for it.

The IA has published a position paper 'Putting investment at the heart of DC pensions[2]' in June this year, where we have argued that a greater focus by DC schemes on considering ESG factors material factors to their investment could not only help better mitigate risk and adjust returns over the long term but could also serve to enhance member engagement and better connect people with their pensions. We have made a number of recommendations to improve member-focused governance and transparency as the foundation of good investment outcomes.

b. Do you agree that the draft regulations meet the policy intent?

N/A – it is only relevant for us to comment on the policy proposals for this 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?

The IA is supportive of initiatives to promote and develop social impact investment, so that our industry can better service both the financial and non-financial investment objectives of our clients. Our industry can play a key role in signposting opportunities and products for investors that contribute to sustainable growth and in the development of innovative products to contribute to savers' objectives.

The IA is actively involved in progressing the work of the Social Impact Investing Taskforce. We have signed up to the Social Impact Investing Statement of Support which commits us to taking forward the five areas of recommendations in the November 2017 Report, "Growing a Culture of Social Impact Investing in the UK":

- improve deal flow and ability to invest in scale;
- strengthen competence and confidence within the financial services industry;
- develop better reporting of non-financial outcomes;
- make it easier for people to invest; and
- Maintain momentum and build cohesion across initiatives.[3]

The IA is also a member of the Taskforce and is represented on multiple Working Groups, and has been tasked with taking forward specific recommendations, including a UK Market Mapping project to demonstrate the variety of sustainable and responsible investment products available.

Notwithstanding these developments and the IA's commitment to progressing social impact investing, we agree with the consultation's proposal not to include a requirement in regulations for trustees to state a policy in relation to social impact investment at this time for the rationale stated in the consultation. Namely that work to strengthen and develop this important market is still in early stages and trustees will better understand the demand for social impact investing once they have begun to better understand their members' views as per the proposals in this consultation. Where pension scheme members unambiguously prioritise non-financial values and where pursuing these values in the investment allocation doesn't result in financial detriment to the scheme, some trustees will make the decision to

[2] Putting Investment at the heart of DC pensions, the Investment Association, June 2018: https://www.theinvestmentassociation.org/assets/files/consultations/2018/20180621-puttinginvestmentattheheartofdcpensions.pdf
[3] https://www.gov.uk/government/publications/growing-a-culture-of-social-impact-investing-in-the-uk

direct more capital towards investments with particular non-financial objectives, including social impact investments. We expect this market will continue to grow as a result.

We agree that these developments should be monitored for evidence of the need for a review of this proposal.

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 our proposals?**

We strongly support the aim of this proposal as it is an important step in creating a better market for stewardship. Stewardship encompasses the myriad activities (including but not limited to setting expectations, research, engagement, voting and collective collaboration with other investors) undertaken by asset managers to look beyond short term performance of the companies they invest in and understand whether they are truly sustainable over the long-term, and if not, take steps to help the company address this. Our industry believes that well run companies that take a long-term approach, are more likely to deliver long term returns for their clients.

A more demanding and discerning client base will help to develop market practice and increase competition in the industry on stewardship. The IA's 2017 Stewardship Survey found that 16% of pension fund respondents had no opinion on whether pension funds have stewardship responsibilities[4]. This often weak demand from asset owners for stewardship means that more needs to be done so that stewardship is a key part of the discussions on the service asset owners are getting from asset managers and so that there is an assessment of the quality of their stewardship services received. In order for asset managers to have the resources to effectively carry out their stewardship duties, client demand for the prioritisation of stewardship is key, particularly in an environment where costs are a key consideration for the end investor.

This important step in requiring trustees to include their policy in relation to stewardship and for this policy to describe the activities wider than voting, will support the development of this market.

Stewardship covers a wider range of activities and issues than described in the proposed regulations. Other matters that our members frequently engage with companies on includes strategy, performance, board composition, diversity, pay and incentives, capital management, culture, human capital and audit and accounting. In addition, stewardship of unlisted assets may not require any voting activity. It is important to recognise that effective stewardship involves choosing the right approach and relevant issues to engage on. These will change dependent on the individual circumstances of the companies they invest in and the material risks and opportunities facing each business at that time.

We think it would be helpful therefore for the regulation to reflect this by amending Paragraph (3) (C) to read "their policies in relation to *(but not limited to)*

i) The exercise of the rights (including but not limited voting rights) attaching to the investments; and
ii) undertaking engagement activities in respect of the investments (including the methods by which and the circumstances under which trustees would monitor and engage with relevant persons and other persons about relevant matters)"

and for "relevant matters to include matters concerning an investee company including *(but not limited to*) its performance, strategy, risks, social and environmental impact and corporate governance"

[4] Stewardship Survey refers to The Investment Association and PLSA 2016 report "Stewardship in Practice"

Regulatory guidance will be essential to help trustees to interpret best practice. Stewardship cannot and should not be boiled down to a checklist and we would expect regulatory guidance to emphasise this point.

The model by which pension schemes delegate their stewardship responsibilities to asset managers will depend on the structure that they invest by, for example via pooled funds or segregated mandates. Pension schemes need to consider how best the model and asset manager they choose is able to meet their investment principles, including their policies on stewardship.

The FRC will consult later this year on the Stewardship Code. We would expect the aim of these regulations to encourage trustees to consider their stewardship obligations and to provide a high level overview of what these obligations look like and point to the Stewardship Code for evolving market best practice.

The IA will also continue to work to develop a better market for stewardship, by improving and drawing attention to the public disclosure of stewardship activities by asset managers. By being more open about how they conduct stewardship, asset managers can help to create awareness of the value of stewardship and help pension schemes to identify the differing approaches of asset managers. A key part of this is developing the IA's Stewardship Reporting Framework[5], which helps asset managers to report on their stewardship activities in a consistent way through a mix of summary statistics and case studies on both engagement and voting.

b. Do you agree that the draft regulations meet the policy intent?

As mentioned above, we think that the proposed amendments should be adapted to make explicit the fact that good stewardship is wider than voting, engagement and monitoring.

More clarity is also needed on the definition of 'relevant persons' as the draft regulations do not indicate the permissiveness of group engagement despite the stated policy intention in the consultation document.

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 our proposals?

We support these proposals as they are essential steps in catalysing the SIP into being more than simply a compliance exercise.

These proposals will have a knock on effect for how performance and compliance with the SIP is assessed via the contractual relationship between pension schemes and their asset managers. The IA is assisting its members to be more transparent about how they conduct their stewardship activities via the stewardship reporting framework as well as working to develop best practice guidance for how the contractual relationship between pension schemes and asset managers is articulated and produces long-term incentives via the

[5] Stewardship Reporting Framework, the Investment Association: https://www.theinvestmentassociation.org/assets/files/Productivity%20Action%20Plan%20_%20IA%20Stewardship%20Reporting%20Framework.pdf

investment mandate. We would expect trustees to seek specific feedback from their asset managers on how they are discharging their stewardship responsibilities and the extent to which the SIP has been complied with and any reasons for deviation. This may be more complex to implement according to the contract period and provisions. Regulatory guidance will again be important to assist trustees to implement these new duties.

b. Do you agree that the draft regulations meet the policy intent?

N/A – it is only relevant for us to comment on the policy proposals for this 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 our proposals?

We support these proposals as the visibility and accessibility of the SIP is important to promote transparency and accountability throughout the investment chain. While we agree that these documents should be referenced in the Annual Benefit Statement, best practice should encourage trustees to consider how else to engage members with these important documents, as they may otherwise be missed. Again, regulatory guidance could explore different options to encourage best practice.

b. Do you agree that the draft regulations meet the policy intent?

N/A – it is only relevant for us to comment on the policy proposals for this 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?

N/A – this questions is not applicable to our members.

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

Clear signalling and demand from asset owners is crucial to creating a market for long-term investment and stewardship. These amendments will go some way towards developing these markets, as trustees will be obliged to give greater consideration to them in their SIP and we would expect them to reflect these in their investment mandates.

We are concerned that other aspects of the SIP and pension mandate are inadvertently embedding a short-term approach to investment and have committed to work further with the DWP, the Pensions Regulator, the PLSA and other key stakeholders to develop best-practice guidance on how stewardship and long-term incentives can be better incorporated into the mandate design and would like to explore:

- How risk appetite can be articulated in a way that it encompasses an appreciation of more than short-term volatility and tracking error, and encompasses real economic risk over the long term;
- How benchmarks can be selected and constructed to focus on long-term value creation;
- How stewardship activities and responsibilities can be best specified and clarified between the asset owner and the asset manager; and
- How to evaluate the long-term performance of asset managers, with a focus on process, behaviours, and consistency with long-term outcomes.
- How the Investment Mandate can operate better as a mutual mechanism for the alignment of behaviours and objectives, rather than principally existing as an expression of legal responsibilities and powers.

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 agree that this clearly explains the essential components of Trustees' new legal duties. However, as referenced in response to all of the above consultation questions more practical guidance on what best practice could look like will be essential to encouraging the behavioural changes that these regulations are targeting.

11. 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?

N/A – this question is not applicable to our members.