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John Reynolds
Financial Conduct Authority
12 Endeavour Square
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Date: 15 July 2019

Dear John,

RE: CP19/15 Independent Governance Committees: extension of remit

The Investment Association[1] welcomes the opportunity to provide input to the FCA's consultation on proposed extensions to the remit of Independent Governance Committees (IGCs) and include below our answers to the specific questions posed.

In addition we have a number of overarching comments:

1. **The importance of stewardship and the incorporation of ESG factors into the investment process**. Stewardship and long-term investment are essential components of a sustainable economy and the IA is supportive of measures to stimulate greater demand for effective stewardship and the management of financially material ESG factors. Given the magnitude of UK pension assets in particular, it is important that such considerations are taken into account by pension schemes in their investment decision-making. Effective demand for stewardship at the critical juncture in the investment chain between asset owners and asset managers will contribute to generating sustainable long term value for savers.

We have previously supported the DWP's efforts for trust-based schemes in this area and we support a similar approach to stewardship and ESG integration being taken in the insurance-based pension and SIPP markets. The implementation of the Revised Shareholder Rights Directive is important in formalising the responsibilities of life insurers (and other asset owners) to enhance the transparency of their engagement policies and investment strategies with regards to listed equities. IGCs have an important role to play as an

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[1] The Investment Association is the trade body that represents UK investment managers, whose 200 members collectively manage over £7.7 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 35% of European assets.

More information can be viewed on our website.

independent overseer of the provider's stewardship policy and approach to taking account of financially material ESG-related factors, including climate change and across all asset classes.

2. **Extending IGC oversight to cover investment pathways**. In our previous responses[2,3] to the FCA's Retirement Outcomes Review work, we indicated that while there may be merit in a limited extension to pathways oversight for existing IGCs operated by firms providing workplace pensions, the case for a more general expansion was less clear, given IGCs' core remit resulting from specific considerations about workplace pension provision. Investment pathways, where a degree of active engagement by the customer does take place, may require a different oversight process.

We strongly agree with the FCA that all customers should benefit from strong oversight mechanisms, and a range of existing and forthcoming governance obligations on firms will help fulfil this function. In particular, the FCA's forthcoming requirements for value assessments for authorised funds, many of which will be used in pathways solutions, impose specific value assessment requirements at the investment fund level. In addition, the FCA proposed in CP19/5 the extension of MiFID II/IDD product governance standards to the manufacture and distribution of investment pathways, a proposal that we support. Taken together these changes will provide robust protection for customers in relation to the design and value of pathways solutions, both at the fund building block level and the overall strategy level.

Subsequently, the FCA has signalled at paragraph 2.35 of CP19/15 that it may seek to bring forward new governance remedies in respect of unit-linked funds, following diagnostic work in this area. Given the prevalence of unit-linked funds in the pensions market (both accumulation and decumulation) it is conceivable that there will be a further set of governance requirements sitting at the fund level in pathway investment products.

With these fund and strategy-level layers of governance in place, there will already be a strong level of oversight of investment pathways. It would be helpful if the FCA could demonstrate how these forthcoming requirements will interact with the IGC regime and in particular, the additional benefit that IGC oversight of the pathways will bring to customers.

3. **Value for money considerations**. We are supportive of an approach that focuses on helping IGCs assess value for money in terms of quality and cost, rather than an approach which focuses on cost as the main or sole factor in determining value for money. Investment outcomes in particular are key to ensuring good outcomes for members and there needs to be a renewed focus on investment governance in the DC market. An emphasis in the value assessment on the design and execution of the investment process will help to facilitate better long-term member outcomes and the FCA should provide guidance that emphasises to pension providers and their IGCs the importance of embedding good governance into the design and on-going monitoring of DC investment strategies, particularly the default.

We highlight two further areas where we believe the value for money assessments would benefit from further enhancements. Firstly we see the need for an additional piece of cost transparency in the context of a bundled workplace pension product – the need for scheme governance bodies to access separately the charge for investment. This will allow for a better assessment of value for money of investment as well as giving scheme decision

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[2] IA response to CP18/17 'Retirement Outcomes Review: Proposed changes to our rules and guidance'.
[3] IA response to CP19/5 'Retirement Outcomes Review: Investment pathways and other proposed changes to our rules and guidance'.

makers the tools to assess whether they are satisfied with the investment budget within the total price of the workplace scheme.

Secondly we see merit in the comparison of default investment strategy performance across the master trust and contract-based workplace pension markets. This should be an important data point for IGCs and trustees to have because it would allow them to compare the investment performance of default strategies across the market and highlight where any action might need to be taken in order to improve performance.

I hope this response is helpful and would be happy discuss it with you further.

Yours sincerely,

Imran Razvi,

Senior Policy Adviser, Pensions & Institutional Market

RESPONSE TO CONSULTATION QUESTIONS

Q1: Do you agree that IGCs should report on the adequacy and quality of their firm's policies on ESG issues, member concerns and stewardship?

1. Stewardship and long-term investment are essential components of a sustainable economy and the IA is supportive of measures to stimulate greater demand for effective stewardship and the management of financially material ESG risk factors, contributing to a better market for long term investment. Given the magnitude of UK pension assets in particular, it is important that such considerations are taken into account by pension schemes in their investment decision-making. The IA therefore supported the DWP's regulations requiring pension scheme trustees to take more explicit account of these factors when designing, implementing and monitoring their schemes' investment strategies[4].

2. It is important that a similar approach to stewardship and ESG integration is taken in the insurance-based pension and SIPP markets where approximately £780bn of assets are held in workplace and personal pension products as well as used to back annuity contracts[5]. In order to achieve this it is important that appropriate responsibilities are placed on the firms that provide the investment strategies that feature in these products. In this regard the implementation in the UK of the Revised Shareholder Rights Directive (SRD II) is important in formalising the responsibilities of life insurers (and other asset owners) to enhance the transparency of their engagement policies and investment strategies with respect to listed equities. The IA has previously expressed its support[6] for the FCA's implementation of SRD II.

3. The role of IGCs in all this is less direct. Unlike trustees, they do not have any decision-making power over the investments of the pension schemes they oversee. The production of an engagement policy under SRD II will assist IGCs in assessing the quality and effectiveness of the firm's approach to stewardship and management of financially material ESG factors including climate change with respect to listed equities. To be meaningful, IGCs will need to form a view on what constitutes effective stewardship and management of financially material ESG factors across all relevant asset classes. As an external source of scrutiny of the insurer's policies and actions in these areas, IGCs could fulfil a useful function.

4. IGCs may also have a role to play in relation to assessing the extent to which member concerns, where applicable, are taken into account in the investment decision-making of firms. Engagement with members on ESG issues could generate greater member interest in their pension. We note however that this remains a challenging area: larger pension 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.

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[4] IA response to DWP consultation on clarifying and strengthening trustees' investment duties, 2018.

[5] Asset Management in the UK 2017-18, The IA.

[6] IA response to FCA CP19/7.

5. We note the definition of stewardship in the proposed rules at COBS 19.5.1A R(7). While this captures some stewardship activity, it does not capture it all. In particular, besides the exercising of voting rights and engagement on areas such as strategy, performance, risk, culture and governance listed in the rules, asset managers frequently engage with companies on wider areas such as diversity, pay and incentives, capital management, human capital and audit and accounting. In addition, stewardship of some asset classes do not require any voting activity and asset managers will exercise their rights in other ways. 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 invested in and the material risks and opportunities facing each business at that time.

6. We think it would be helpful therefore for the rules to reflect this by amending COBS 19.5.1A R(7) to state that:

   *" "stewardship" relates to a firm's exercise of rights, **oversight and** engagement activities in the investments attributable to the firm's relevant policyholders or pathway investors, and may include**, but is not limited to**:*

   (a)…;

   *(b)…; **and***

   (c) environmental and social factors (including climate change) affecting the long-term sustainability of an investment."

Q2: Do you agree that IGCs should report on how the firm has implemented its policies on ESG issues, member concerns and stewardship?

7. Yes, we see the benefit of an external body commenting on how effectively a firm has implemented its policies in these areas. This will need to be informed by effective disclosures by the firm to its IGC on the activities and outcomes of its stewardship activities, over and above its policies and processes. As the FCA notes, independent oversight of how a firm has implemented its policies can help ensure a firm follows them.

Q3: Do you agree that IGCs should report on the firm's policies on these issues for both pathway solutions and workplace personal pensions?

8. We do not disagree with requiring IGCs to report on these issues for both workplace pensions and pathway solutions. We note the importance of SRD II and the FCA's proposed guidance in SYSC 3.2.23 and SYSC 4.1.15 in ensuring that ESG and stewardship issues are taken account of across the full range of investment products offered by firms – not just workplace pensions and pathways investments.

9. Since the IGC role is necessarily limited to oversight of workplace pensions and pathways investments, this does mean there is a gap in external oversight of firms' approach to implementing ESG and stewardship policies in investment strategies offered in other product lines. To be clear we do not think the answer here is to extend IGC responsibilities beyond these two product lines (there is a risk that IGCs' effectiveness could be diluted if their remit is stretched too far) but it does raise the question of whether there should be external oversight by some other body in relation to investments offered in products besides workplace pensions and pathway investments.

Q4: Do you agree that firms should make the IGC's annual report publicly and prominently available, with 2 prior year reports for comparison?

10. Yes, we agree with the proposal.

Q5: Do you agree that the proposed guidance should apply more widely, to all firms that provide pension products and all life insurers that provide investment-based life insurance products?

11. Yes, we agree that the guidance should apply more widely than simply to firms providing workplace pension and investment pathways products. We consider that ESG and stewardship considerations should be applied to investments made regardless of the product wrapper that the investments are provided within.

12. With regards to the specific wording of the guidance in the proposed sections 3.2.23 G(2)(a) and 4.1.15 G(2)(a), we would suggest that the wording is amended as follows to better align with the DWP's investment regulations for trust-based DC schemes and to refer to financially material *considerations* instead of risks (which will apply to the consideration of both risks and opportunities):

    "(2) As part of its investment strategy and decision making, a firm/personal pension scheme operator should take into account financial considerations including:

    (a) ***financially material, environmental, social and governance considerations (including but not limited to climate change);***

    (b)…."

Q6: Do you agree that we should focus our requirement for an IGC on firms offering pathway solutions to consumers?

13. Yes, we agree it makes sense to target the IGC requirement only on those firms actually offering pathways solutions. It is likely that, as with workplace pension default strategies, pathway investment solutions will be composed of multiple building block funds provided by (possibly) multiple asset managers. The IGC should be focused on the overall pathway strategy rather than the underlying fund building blocks[7] and so targeting the IGC requirement on the pathway provider is appropriate.

Q7: Do you agree with our proposed approach for providers with smaller numbers of non-advised consumers entering drawdown?

14. Yes, we agree that for providers with a small number of non-advised customers entering drawdown, the option of using a Governance Advisory Arrangement (GAA) provided by a third party is likely to represent a more cost-effective and appropriate solution to implementing the FCA's proposed governance duties for pathway solutions. This flexibility may be the difference between a small provider being able to offer pathway investments or not. We therefore agree that the option to use a GAA is a proportionate approach.

Q8: Do you agree that IGCs must be in place in time to assess the initial designs of pathway solutions?

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[7] These fund building blocks will themselves be subject to AMMS fund governance remedies and/or any governance remedies the FCA proposes for unit-linked funds.

15. While we do not see any harm in having the IGCs in place prior to the pathway solutions actually being offered, we do not place the same emphasis on this as the FCA. A crucial part of the value for money assessment will be the on-going performance of the pathways investments and this can by definition only be assessed once the solution has been set up and customers are invested in it.

16. On-going assessment of value for money is as important as any assessment prior to the pathways being offered and so we do not place any special emphasis on IGCs being in place in time to assess the initial designs of pathway solutions. Indeed we do not see how a meaningful value for money assessment can be conducted without an assessment of ex-post performance.

Q9: Do you agree that we should be more prescriptive in our rules and guidance for firms and/or IGCs on how value for money should be assessed?

17. We are supportive of an approach that focuses on helping IGCs assess value for money in terms of quality and cost, rather than an approach which focuses on cost as the main or sole factor in determining value for money. We recognise that the existing IGC rules in COBS 19.5.5 R(2) already make it explicit that there should be consideration of default strategy performance and service quality, alongside cost, as part of the value for money assessment.

18. Therefore we see no further need for prescription in the rules. However, we do consider that guidance, in relation to DC investment strategies in particular, might assist IGCs because our observation is that, notwithstanding the mention of factors beyond cost in the rules, the DC workplace pensions market has been dominated by a debate focused primarily on cost[8].

19. Investment outcomes are key in ensuring good outcomes for members. Accordingly we think there needs to be a renewed focus on investment governance in the DC market. An emphasis in the value assessment on the design and execution of the investment process will help to facilitate better long-term member outcomes. We think there is scope for the FCA to emphasise to pension providers and their IGCs the importance of embedding good governance into the design and on-going monitoring of DC investment strategies, particularly the default.

20. The key elements of such an approach include the need for a clearly identified member-focused objective for any default arrangement that answers the question: "what are you trying to achieve for the members?" For some, this may be related specifically to an ambition to deliver in excess of inflation, preserving purchasing power. For others, it may be more general, relating to maximising return while controlling risk.

21. Once specified, the member objective should then be delivered with an appropriate investment strategy, whose performance net of fees should be monitored on an on-going basis to ensure that it is delivering against the member objective. The member objective itself should be reviewed over time to ensure that it remains suitable for the scheme membership.

22. We highlight two further areas where we believe the value for money assessments would benefit from further enhancements. Firstly we see the need for an additional

[8] For a detailed discussion of this, see the IA's 2018 policy paper 'Putting investment at the heart of DC pensions'.

piece of cost transparency in the context of a bundled workplace pension product – the need to show separately the charge paid for investment.

23. Investment performance is best judged net of the charge paid for its delivery, and not simply net of the total charge paid for the additional services that form part of a bundled workplace pension product – administration, communication, governance etc. For this reason, we recommend that IGCs (and indeed trustees) should be able to access the charge (and delivery) of the investment component of a workplace pension product separately – rather than a bundled product charge alone.

24. Considering the charge paid for investment separately from the total charge for a workplace pension product would allow scheme governance bodies to make a better assessment of value for money of investment as well as giving scheme decision makers the tools to assess whether they are satisfied with the investment budget (i.e. the charge allocated to the scheme's investment strategy) within the total charge paid for the scheme. Achieving this in practice will require careful consideration because of the variety of business models across firms, but the principle is an important one.

25. Secondly we see merit in the comparison of default investment strategy performance across the master trust and contract-based workplace pension scheme markets. This should be an important data point for IGCs and trustees to have because it would allow them to compare the investment performance of default strategies across the market and highlight where any action might need to be taken in order to improve performance.

26. For employers this information would be useful to have when making scheme selection decisions as part of their auto-enrolment duties. It is important to include both trust and contract-based providers in this exercise because these are substitutable products for employers selecting pension schemes.

27. This is an area that would require the FCA to work with TPR and pension providers, both trust and contract-based. We recommend that alongside any such work, the FCA includes in any new value for money guidance aimed at IGCs the need to compare default investment strategies across the market.

Q10: We welcome your view on what legacy pension products should be compared with, when assessing value for money.

28. Pension providers are best placed to comment about legacy pension products, but in relation to the investment strategies inside these products, the design and cost of modern strategies should be an appropriate benchmark for legacy products.

Q11: Do you agree with the conclusion and analysis set out in our cost benefit analysis?

29. We do not have any comments on the CBA.