NAPF

Securing the future of pensions

Consultation on Changes to the Investment Regulations following the Law Commission's report – Fiduciary Duties of Investment Intermediaries'

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About the NAPF

The NAPF is the voice of workplace pensions in the UK. We speak for over 1,300 pension schemes that provide pensions for over 17 million people and have more than £900 billion of assets. We also have 400 members from businesses supporting the pensions sector.

We aim to help everyone get more out of their retirement savings. To do this we spread best practice among our members, challenge regulation where it adds more cost than benefit and promote policies that add value for savers.

Summary

The NAPF welcomes the opportunity to respond to this consultation on proposed changes to the Occupational Pension Scheme (Investment) Regulations. The proposals to a large extent echo those which the NAPF previously advocated during the Law Commission's comprehensive review of the fiduciary duties of investment intermediaries.

The Law Commission's conclusions have we believe brought important clarity to the role of fiduciary concepts in pension scheme management - an area of the law that has too often been clouded with myths or misinterpretations.

We continue to believe that it would not be beneficial to seek to clarify fiduciary responsibilities further through statute or by imposing a more explicit duty to consider specific factors when devising an investment strategy - such an approach would be very difficult to appropriately draft, struggle to keep pace with emerging best practice and investment trends and indeed impinge upon the flexibility that is currently so beneficial. Instead, we support efforts to catalyse further discussion at trustee board level about a scheme's investment approach and how the approach appropriately incorporates consideration of the full range of factors which may have a material financial impact on its investment portfolio over the time-horizon in which it is investing.

Furthermore, we believe that any discussion about how an investment strategy appropriately incorporates consideration of the full gamut of relevant factors should also include a discussion about the fulfilment of associated stewardship responsibilities. Indeed, our regular survey of NAPF members indicates that there is a near universal recognition amongst the largest UK occupational pension funds that they do possess stewardship responsibilities, even if, as is common, the activity itself is delegated to investment managers.

It is right that, as principals, pension funds develop an investment policy which includes an understanding of their objectives and risks and also clearly conveys their expectations to their agents with respect to delegated activities such as engagement and voting. Our only caution however, is that a balance needs to be struck between encouraging the right behaviours whilst avoiding introducing measures which risk creating a compliance tick-box exercise with boiler-plate disclosures. It is for this reason that, instead of requiring trustees to comply-or-explain with the Stewardship Code we suggest that a fund's approach to the stewardship of its investments should be included alongside the proposed disclosures about how it considers financial and non-financial matters.

Will Pomroy, NAPF

Consultation questions

1. **How could regulation 2(3)(b) of the Investment Regulations be amended so that it more clearly reflects the distinction between financial and non-financial factors?**

We consider that regulation 2(3)(b) of the Investment Regulations 2005 can be amended in such a way as to prompt appropriate discussions amongst trustees and to result in useful and purposeful disclosures within the Statement of Investment Principles.

Whilst we agree that it would not be appropriate for the regulations to prescribe either that a particular investment approach is adopted or indeed that specific granular factors should be considered, it is equally the case that the regulations should not inadvertently relieve investors of their responsibilities. At present the current wording of the regulations has unintentionally resulted in a situation whereby important investment considerations which are commonly termed to be non-financial, extra-financial or perhaps most commonly environmental, social or governance (ESG) have been grouped together with other issues which stem from moral or ethical beliefs.

That the wording of 2(3)(b)(vi) currently uses language that conflates the consideration of financially material and of non-financial factors is unfortunate; equally, and perhaps as a result of this, the current clause suggests that the consideration of these factors – either the former or the latter – is an opt-in or nice to do. This situation has not therefore been helpful in always prompting the right conversations and ensuring that there is a clear conveyance of expectations between pension funds and their investment managers.

The Law Commission's conclusions have proven very helpful in putting to bed any misunderstandings which may have still existed amongst trustees, and also amongst their various advisers. As evidence of this, when we surveyed our members through our annual Engagement Survey – published in December 2014 - not a single respondent disagreed with the statement that active consideration of risks to a company's long-term sustainability, such as environmental, social or governance factors (often referred to as "ESG" factors) is compatible with its fiduciary duty. Furthermore, 90% of the respondents also agreed that extra-financial factors – environmental, social and governance factors – can have a material (financial) impact on the fund's investments in the long-term.

Given the above we believe that it is both possible and helpful to replace 2(3)(b)(vi) with two separate clauses. One should more effectively encourage discussion as to how, in the context of the scheme's investment objectives, it ensures that all of those risks which may have a material impact on its investments over the time-horizon in which it is investing are being considered. The second should encourage clearer articulation about the approach a scheme may, or may not take, to considering non-financial factors.

Importantly, with respect to the first clause this should acknowledge that this is a process which in the vast majority of circumstances would require engagement with advisers and investment managers.

With respect to the second clause, this would likely benefit from being worded in a fairly open manner. Some schemes will of course have more flexibility than others in this area by din of their origins and DC schemes are likely to have more scope for addressing these issues than their DB counterparts.

The below wording would we believe would go some way towards better reflecting the distinction between financial and non-financial factors:

Suggested wording

3. A statement of investment principles must be in writing and must cover at least the following matters—

   a) the trustees' policy for securing compliance with the requirements of section 36 of the 1995 Act (choosing investments);

   b) their policies in relation to—…..

      vi. Directly or indirectly evaluating longer-term risks, including from environmental, social, governance (ESG) and other factors, which may become financially material to the performance of their investments;

      vii. The extent (If at all) to which they may consider making investment decisions on the basis of non-financial factors (such as ethical beliefs).

2. Do you agree that amending the Investment Regulations to require trustees to comply with the current requirements in the Stewardship Code or explain why they have not done so, is the most appropriate way to implement the Law Commission's recommendation?

If not, what approach would be more appropriate to encourage trustees to consider their approach to stewardship?

Stewardship is an important concept and one that rightly resonates with trustees as guardians of their members' savings. It is perhaps for this reason that when asked whether they have stewardship responsibilities, 94% of respondents to our 2014 Engagement Survey agreed that they do.

The NAPF advocated during the Law Commission's review for the recommendation that trustees should be encouraged to consider and subsequently disclose within the SIP their stewardship policy. This should endeavour to explain how the scheme, commonly through its' agents, seeks to promote the long term success of investee companies.

The Stewardship Code explains that for investors, stewardship activities include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings. This is an explanation which the NAPF supports.

Significantly, there are two important caveats. Firstly, for the vast majority of pension funds the day-to-day investment decisions are delegated to investment managers, this includes the stewardship activities associated with particular investments. Secondly, dependent upon the particular investment strategy it is possible that all, some, or none of the above mentioned stewardship activities would be appropriate.

What is necessary is for there to be a discussion about where and how stewardship responsibilities are exercised and for this conversation to likely go hand in hand with the discussion about how all material financial risks are monitored and considered within investment decisions.

In 2012, the NAPF published a Stewardship Policy. This policy essentially set out three simple actions which can be expected of pension funds as the owners and providers of capital:

1. Include a section on 'stewardship' within the fund's Statement of Investment Principles.

2. Include stewardship criteria in manager searches

3. Incorporate monitoring of stewardship activities into manager reviews.

These suggested actions reflect the reality that most pension funds do not have the internal resources available to monitor and engage with investee companies and additionally the voting rights lie with their investment managers. Equally however, as the Stewardship Code acknowledges, whilst it is perfectly reasonable to delegate the activities associated with stewardship, the responsibility remains with the pension scheme to convey their expectations to their agents and hold them accountable for delivering.

In order to assist our members and asset owners more broadly, the NAPF has in recent years provided a range of tools to enable funds to more easily compare the approaches of different firms and to collectively question firms about their activities. More information about the NAPF's Stewardship Disclosure Framework and Stewardship Accountability Forums can be found at www.napf.co.uk/stewardship

The NAPF has been a long-standing and vocal supporter of the Stewardship Code and has encouraged and helped facilitate more asset owners becoming signatories to the Code; it remains our belief that a greater weight of pension fund signatories to the Code will send an important signal and further influence behavioural changes that lead to better stewardship by asset managers and companies. However, we would be reticent about the Investment Regulations requiring trustees to comply with the current requirements in the Stewardship Code or to explain why they have not done so.

The Stewardship Code's seven principles essentially speak to the stewardship activities which would be expected to be undertaken by investment managers - or other third parties – they do not directly talk to the role and responsibilities of pension funds as we have described above.

If the objective is to encourage pension schemes to reflect on their investment objectives and how stewardship relates to these we fear that simply asking schemes to comply against principles which do not talk to their responsibilities will not help. We believe it would be preferable for pension schemes to disclose under the amended Regulation 2(3)(b) of the Investment Regulations their policy, if any, with respect to the consideration of stewardship activities when selecting investment managers and reviewing their performance. This would be particularly pertinent in the context of pension schemes' evaluation of long-term risks, including from ESG and other factors which may be financially material to the performance of their investments.

Suggested wording

3. A statement of investment principles must be in writing and must cover at least the following matters—

c) the trustees' policy for securing compliance with the requirements of section 36 of the 1995 Act (choosing investments);

d) their policies in relation to—…..

viii. the undertaking of stewardship activities (as set out in the UK Stewardship Code) including whether consideration of these activities is incorporated into the selection and monitoring of investment managers and other third parties.

The ultimate objective should not be increasing the number of signatories to the UK Stewardship Code but about achieving the behavioural change through the investment chain that was described as necessary by the government commissioned Kay review. The quality of Code signatories should matter more than quantity. It can for example be argued that presently there are too many asset management signatories for whom their true commitment to the Code's principles may be questionable. Replicating this scenario with a list – extending into the thousands - of potentially boilerplate asset owner statements would not be helpful.

3. What steps would trustees need to take to comply with any amendments to the Investment Regulations, as set out in Chapter 2?

What, if any, costs would be involved in meeting any new requirements?

In most cases the potential cost impact associated with complying with the proposed amendments should not be significant but would likely encompass legal and investment consultancy costs.

In general terms the likely costs would relate to one-off costs associated with debating and settling upon a policy and subsequently the resultant additional time needed to review and monitor additional aspects of reporting from their investment managers - likely with the support of their investment consultants. For many, making use of the tools provided by the NAPF would go a long way to fulfilling the new policy objectives.

It is worth noting however, that for others there may well be additional costs as their approaches and processes became more sophisticated. In turn these schemes would likely require further increased use of investment consultants, third party providers of research and other services and recruitment of additional FTE personnel. We would not expect that for these schemes this additional resource would be disproportionate.