24 April 2015

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Via Email: caxtonhouse.legislation@dwp.gsi.gov.uk (external)

Re: **Consultation on Changes to Investment Regulations**

Dear Mr. Koufou:

Participants in the Network for Sustainable Financial Markets (SFM) appreciate the opportunity to submit these comments regarding Department for Work & Pensions (DWP) changes to pension investment regulations following recommendations in the Law Commission's Report on Fiduciary Duties of Investment Intermediaries. The SFM is a network of financial professionals, academics and others who share a commitment to collaboration on fostering sustainable financial practices.[1]

Several of the SFM signatories to this letter are editors or contributing authors to the Cambridge Handbook on Institutional Investment and Fiduciary Duty. In addition, SFM participants submitted comments on the Kay Review consultation draft and in response to the Law Commission's consultation on Fiduciary Duties of Investment Intermediaries. We bring expertise and experience to the questions in your consultation.

Long-term Investments for Long-term Liabilities

We see the need for better balance between short- and long-term investing as providing the foundation for responses to all three of the consultation questions. The Law Commission also shares this view.

> *"When investing in equities over the long-term, the risks will include risks to the long-term sustainability of a company's performance. These may arise from a wide range of factors, including poor governance or environmental degradation, or the risks to a company's reputation arising from the way it treats its customers, suppliers or employees. A company with a poor safety record, or which makes defective products, or which indulges in sharp*

[1] These comments are offered by the undersigned as individuals and not as representatives of any organizations with which they are affiliated. Additional information on SFM is available at sustainablefinancialmarkets.net.

practices also faces possible risks of legal or regulatory action. . . Where poor business ethics raise questions about a company's long-term sustainability, we would classify them as a financial factor which is relevant to risk." [Paragraphs 1.16 and 117, Pension Trustees' Duties when Setting an Investment Strategy: Guidance from the Law Commission.[2]]

In addition, the Law Commission recognizes that the fiduciary duty of impartiality mandates a fair balancing of both current and future factors. This includes risks and opportunities that can influence short- or long-term performance and value at a particular company, throughout a portfolio or across asset classes, as well as on a systemic basis for the broad economy.

"In some circumstances, damage to the wider economy might be considered a financial factor, as it will impact on the scheme's portfolio as a whole. The wider economic effect of a takeover may impair trustees' ability to generate returns over the longer term. In the Consultation Paper we said that the aim of a pension fund is to secure returns across the whole portfolio. Therefore there can be no legal objection to making a decision which, after due consideration, is designed to provide financial benefits to the portfolio as a whole." [Paragraph 6.53, Law Commission Report.[3]]

"It is important that trustees adopt an appropriate time-frame over which they formulate their investment strategies. Investment strategies which aim to produce higher returns in the short-term but may endanger the financial viability of the scheme in the long-term will have a disproportionate impact on younger members. . . Whilst the appropriate strategy is matter for trustees' discretion, they should take care to comply with the duty of impartiality and evenhandedness." [Paragraph 7.17, Law Commission Report.[4]]

Much has changed in the pension investment industry over the past decade. We see the Kay Review, the Law Commission Report and this consultation as indicators that the legal profession and government regulators are struggling to catch up with evolving investment fiduciary practices in response to changed circumstances and thinking in response to the recent global financial and developing environmental crises.[5] As investment professionals and academics, we expect this evolution to continue as new practices and insights spread.[6]

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[2] See http://lawcommission.justice.gov.uk/docs/lc350_fiduciary_duties_guidance.pdf. The Law Commission also advises, " Whilst it is clear that trustees may take into account environmental, social and governance factors in making investment decisions where they are financially material, we think the law goes further: trustees should take into account financially material factors." Law Commission Report, Par. 6.30.

[3] http://lawcommission.justice.gov.uk/docs/lc350_fiduciary_duties.pdf.

[4] *"[Trustees] should assume that their members will judge the success of the investment policy by the size of the pension they receive on retirement. However, younger members will judge the investment strategy in the long-term, which requires a long-term approach. Members will have little interest in immediate high returns if the result is an accumulation of risks, leading to a lower pension in forty years' time." Id.* at 5.38.

[5] Without limitation, economic challenges for investors include the financial effects of climate change, water shortages, pollution, growing income disparity, increased market short-termism, declining pension security, flawed investment theories, concentration of assets in systemically important institutional investors, etc.

[6] For example, work of the Sustainable Accounting Standards Board and the International Integrated Reporting Council are ongoing and relate directly to issues which are covered by this consultation. See http://www.sasb.org/sasb/ and http://www.theiirc.org/.

The primary challenge we see for the DWP in crafting new regulations that implement the Law Commission's advice is to facilitate transition to improved fiduciary investment practices, while simultaneously proscribing improper behaviours. New regulations should be designed to promote real changes in behaviour, as well as investment and corporate governance decisions, and should discourage compliance-oriented, boilerplate disclosures.

We will highlight the insights developed by an investment industry initiative devoted to Focusing Capital on the Long Term (FCTL).[7] Like the FCTL initiative, our view is that regulatory guidance on stewardship and on consideration of traditional financial and environmental, social and governance (ESG) value/risk drivers will have little influence on the actions of investment fiduciaries and on corporate governance unless it also directs pension governing bodies and their service providers to focus on the long-term. In particular, regulations should require periodic evaluation of governance practices to ensure they are fit for purpose. Otherwise, many fiduciaries will continue to lag in recognition of knowledge base developments and application of improved governance, investment, risk management, benchmarking, performance measurement, incentive compensation and reporting practices to implement the Pension Regulator's stewardship and ESG guidance.

<u>Q-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?</u>

On a practical level, there are six areas where regulatory guidance could foster a better balance between short- and long-term obligations of pension investors.

- Clear articulation of appropriate investment beliefs;
- Development of a risk appetite statement;
- Selection of benchmarks that measure sustainable value creation;
- Structuring metrics, incentives and evaluations to be consistent with beneficiary interests;
- Construction of investment mandates to align mutual expectations;
- Adoption of interactive communication and reporting processes to promote accountability.[8]

One benefit of a balanced long-term investment program is that material financial and risk factors become more naturally integrated into the investment process. They no longer need to be artificially inserted into the investment analysis as an additional consideration. Development of a custom set of investment beliefs is central to integration of the governing fiduciary's views on ESG factors into the investment process. These investment beliefs can also recognize that traditional financial and ESG value drivers' are actually financial in the longer term, and can materially impact both future cash flows and company valuation.

[7] http://www.fclt.org/en/home.html.

[8] A robust two-way communication and reporting discipline throughout the stakeholder and service provider chain would improve understanding, stewardship and engagement between companies and investors, better align oversight practices between asset owners and asset managers, and foster investment practices that reflect beneficiary interests (rather than unconscious service provider biases).

Investment beliefs are 'assertions about investments and the way the investment world works which, when developed and shared, help with investment decision making.'[9] We recommend that the DWP require fiduciary investors to engage in a guided process to formalize (over a period of time) the investment beliefs that reflect their fiduciary obligations and guide their investment and governance strategies for the long term.

We also recommend that trustees be required to disclose the process by which they have developed their investment beliefs and to explain how they have ensured that all relevant long-term factors have been taken into account, including what research they have conducted and what advice they have sought. We further recommend that The Pension Regulator prepare guidance setting out the characteristics of an appropriate process for the development of investment beliefs.

The following examples are excerpts from actual investment belief statements of mainstream institutional investors.[10]

> *"The way APG manages its clients' pension assets is about more than realizing financial gains. On behalf of our clients we implement the Responsible Investment Policy. Therefore we take account of environmental, social and governance (ESG) factors as an integral part of the investment process in order to: contribute to risk-adjusted financial returns; demonstrate social responsibility and; contribute to the integrity of financial markets." Responsible Investing, APG, 2015, apg.nl.*

> *"We believe that integration of responsibility in investment decisions contributes to a high risk-adjusted return." Responsible Investments, ATP, 2015, atp.dk.*

> *"We believe companies that take environmental, social and governance (ESG) matters into account have less risk and generate better long-term value than do companies with less robust practices." Responsible Investing, bcIMC, 2014, bcimc.com.*

> *"The Trustee has a fiduciary responsibility to meet the Scheme's liabilities and as a long-term asset owner considers sustainable factors to improve long-term risk-adjusted returns. The area of sustainability as defined by the Trustee covers long-term factors such as environmental, social and governance (ESG) and stewardship." Responsible Investment, BT Pension Scheme, 2015, btpensions.net.*

> *"CPPIB believes that responsible corporate behaviour with respect to ESG factors can generally have a positive influence on long-term financial performance, recognizing that the importance of ESG factors varies across industries, geography and time." 2014 Report on Sustainable Investing, CPPIB, 2014, cppib.com.*

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[9] Urwin, R. and Woods, C. (2009) Sustainable Investing Principles: Models for Institutional Investors. Available at http://uksif.org/wp-content/uploads/2012/12/URWIN-R.-and-WOODS-C.-2009.-Sustainable-Investing-Principles-Models-for-Institutional-Investors.pdf

[10] The belief statements include those highlighted in the *Long-Term Portfolio Guide: Reorienting portfolio strategies and investment management to focus capital on the long term* (March 2015) at http://www.fclt.org/content/dam/fclt/en/ourthinking/FCLT_Long-Term%20Portfolio%20Guide.pdf.

Responsible investors must have concern for environmental, social and governance factors because they are material to long-term returns." Investment Beliefs,The Guardians of New Zealand Superannuation, NZSF, 2014, nzsuperfund.co.nz.

"Good governance is good business and contributes to sustainable values. We continually consider all risks in our investment process, including those related to environmental, social and corporate governance factors. We expect management teams and boards of directors to be responsive to their shareholders. We lead by example." Our Investment Beliefs, OTPP, 2015, otpp.com.

"A sustainable, viable world is necessary in order to generate sufficient returns over the long term. […]Making sustainability an integral part of the investment policy therefore contributes to returns over the long term." PFZW, 2015, www.pfzw.nl[11]

"We believe that environmental, social and corporate governance (ESG) factors are likely to have an increasingly material impact on the long-term returns of investment portfolios." Responsible investment, QIC, 2015, qic.com.au.

"We recognize that environmental, social and governance (ESG) issues can adversely impact on the Fund's financial performance and should be taken into account in the funding and investment strategies." Responsible investment, EAPF, 2015, eapf.org.uk.

"Responsible investing requires a full view of risks and opportunities. Environmental, social and governance (ESG) factors should be integrated into the investment process of our managers, whether in-house or external." Investment Beliefs, USS, 2015, uss.co.uk.

"The WSIB has a long investment horizon and therefore is subject to complex and systemic global risks that unfold over time, including financial risks resulting from global climate change. Many of these risks are difficult to quantify, but nevertheless, we consider all identifiable risks in our investment process and believe thoughtful consideration of these evolving global challenges is inseparable from long-term investment strategy and performance." WSIB Investment Beliefs, WSIB, 2015, sib.wa.gov.

<u>Building trustee capabilities</u>

It is also important that trustees have the requisite longer-term cognitive thinking, skills and knowledge to enable them to develop investment beliefs and strategies that strike the appropriate balance between long- and short-term objectives, and to ensure alignment of the investment chain and its incentives with these objectives. We therefore recommend that The Pensions Regulator strengthen its trustee toolkit to reflect the approach set out here, and that it devote more attention to trustee selection and ensuring that trustees have (and maintain) the necessary knowledge and skills. For example, pension funds could be required to provide annual statements on how they have identified and met trustee training needs, as is the case in Australia.

[11] Pensioenfonds Zorg en Welzijn. (undated) Investment Framework 2013-2020 (in Dutch). Available at http://www.pfzw.nl/Documents/Over-ons/PFZW_Boekje_Beleggingskader.pdf

Q-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?

For investors with long-term obligations that require sustainable capital growth, returns on capital and cash flows, interaction between shareowners and investee companies is an integral part of the investment management and corporate governance processes. The mainstream investor participants in Focusing Capital on the Long Term Initiative describe the challenges facing both companies and investors.

> *"Too many investors continue to seek returns on their strategies as quickly as possible. Companies are missing out on profitable investments for fear of missing quarterly earnings guidance. Corporate management significantly undervalues and underinvests in longer-term prospects. Savers are missing out on potential returns because stock markets are penalizing companies that make long-term investments. Society is missing out on long-term growth and innovation because of underinvestment."*[12]

Stewardship should seek to improve the dialogue between investors and corporations to help unlock current value and create future value through informed engagement and active long-term ownership. The DWP could encourage more productive stewardship by requiring a balance between short-term tactics and support for long-term strategies that promote sustainable value through investment in innovation, research and development, capital improvements and a skilled workforce. Indeed, the fiduciary duty of impartiality contemplates that investors with both current and long-term obligations seek to maintain equilibrium in management of current and future commitments. [13]

We prefer a 'comply and explain' approach to stewardship. In addition, DWP regulations should recognize proxy voting decisions as a stewardship function and encourage development (over a period of time) and implementation of a long-term investment stewardship component.

Q-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?

We believe a more appropriate question is whether the reduction of risks and improved allocation of capital to long-term sustainable growth outweighs the costs of implementing a regulatory approach aimed at fostering a long-term investment view which integrates the recognition of traditional financial and ESG value drivers into the investment process and encourages alignment of stewardship with sustainability. Such a cost-benefit analysis should be done at the pension scheme participant level, rather than focusing only on short-term benefits and costs to agents or service providers. It should also recognize long-term systemic and

[12] A Roadmap for Focusing Capital on the Long Term (March 2015) at http://www.fclt.org/content/dam/fclt/en/ourthinking/%27FCLT_A%20Roadmap%20for%20FCLT%27.pdf.

[13] http://www.businessinsider.com/larry-fink-letter-to-ceos-2015-4 and http://www.mckinsey.com/insights/strategy/our_gambling_culture

portfolio-wide benefits and reduced financial risk exposures that will accrue to participants, both individually and as members of society. While it might not be feasible to conduct a definitive cost-benefit analysis, we think that the benefits clearly outweigh the costs and risks of doing nothing.

We attach two documents that provide a roadmap to reform and identify the factors that must be addressed.

- *Ambachtsheer Letter, Investing for the Long-Term: From Saying to Doing (April 2015)*
- *The Long-Term Portfolio Guide: Reorienting Portfolio Strategies and Investment Management to Focus Capital on the Long Term (March 2015)*

Both start from the observation that the pension fund investment industry is facing an implementation deficit.

> *"In a recent study of public and private pension and sovereign wealth funds, respondents overwhelmingly agreed that while the ability to invest long-term is an advantage, they do not necessarily have an effective set of implementation strategies/tools to help them realize their aspirations . . ."*

They then lay out a framework for easing the transition that is already underway toward the recognition and integration of traditional financial and ESG value drivers into a sustainable investment approach that balances current demands with long-term needs. We recommend incorporating this reform roadmap into the DWP's investment regulation amendments.

We hope these comments will be of help to the Commission in finalizing its report. Please do not hesitate to contact us at aida@sustainablefinancialmarkets.net if we can be of further assistance.

Respectfully submitted,

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