UKSIF
UK Sustainable Investment
and Finance Association

8th October 2014

John Reynolds
Life and Pensions Policy
Policy Risk and Research Division
Financial Conduct Authority
25 The North Colonnade
Canary Wharf
London E14 5HS

Dear Mr Reynolds,

Thank you for the opportunity to comment on the Financial Conduct Authority's (FCA) consultation CP14/16 *"Proposed rules for Independent Governance Committees"*. We are grateful for the opportunity to have met you on 21st August to discuss our thoughts.

Our response draws on member feedback and discussion of the issues with interested parties. We answer the 31 questions posed in the consultation at the end of this response but first we outline our views on three key issues as context:

- Developments in pension fund investment management
- The growing importance of the Government's agenda on stewardship
- Environment, social and governance risks in investment

About UK Sustainable Investment and Finance Association

The UK Sustainable Investment and Finance Association (UKSIF) is the membership network for sustainable and responsible financial services in the UK. We promote and support responsible investment and other forms of finance that advance sustainable economic development, enhance quality of life and safeguard the environment. We also seek to ensure that individual and institutional investors can reflect their values in their investments.

UKSIF was created in 1991 to bring together the different strands of sustainable and responsible finance nationally and to act as a focus and a voice for the industry. UKSIF's 250+ members and affiliates include financial advisers, institutional and retail fund managers, pension funds, banks, research providers, consultants and NGOs. For more information about UKSIF, please visit www.uksif.org.

1. **Our views on the changing nature of pension fund investment**

The investment approach practiced by UKSIF members is focused on the long-term and considers a wide variety of non-financial factors which for convenience may be called "ESG", standing for Environmental, Social and Governance (see below). This approach has become increasingly mainstream, particularly amongst pension funds, and growing acceptance is shown not only by the breadth of our membership but by important regulatory and quasi-regulatory developments. In 2011, the Kay Review[1] stressed, among other important recommendations, that 'stewardship' should be developed further, that short-termism be addressed, and that "fiduciary standards" be applied throughout the value chain. We would summarise Kay's desired state as one of informed investors operating for the long-term in the interests of savers. We see this as a desirable state.

A Law Commission report on Fiduciary Duty[2] published this year has made it clear that this concept - which is central to <u>defined benefit</u> pension funds - should be interpreted more widely than has been assumed by some sectors of pension fund investment. We believe this notion of informed investors operating for the long-term in the interests of beneficiaries and savers would be a natural foundation to build <u>defined contribution</u> pensions and the basis from which Independent Governance Committees (IGCs) should operate. A summary of the draft guidance prepared by the Law Commission for trustees includes the following:

> *"When investing in equities over the long-term, trustees should consider, in discussion with their advisers and investment managers, how to assess risks. This includes risks to a company's long-term sustainability."*[3]

We think defined contribution schemes and IGCs should adopt this thinking.

UKSIF believes that, as far as possible, IGCs should reflect the role and responsibilities of trustees of DB pension schemes. They should consider the process by which they assess risks, assess the value for money delivered by schemes and report on how they meet quality standards. We believe that considerations of long-term sustainability and the integration of ESG factors are intrinsically linked to the value of an investment and should therefore be included in the remit of an IGC.

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[1] Kay review of UK equity markets and long-term decision making. July 2012. https://www.gov.uk/government/consultations/the-kay-review-of-uk-equity-markets-and-long-term-decision-making

[2] Fiduciary Duties of Investment Intermediaries. July 2014. http://lawcommission.justice.gov.uk/areas/fiduciary_duties.htm

[3] http://lawcommission.justice.gov.uk/docs/lc350_fiduciary_duties_guidance.pdf at paragraph 1.22

2. The government's agenda on stewardship

The Financial Reporting Council comments on stewardship as below:

> *"Stewardship aims to promote the long-term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship benefits companies, investors and the economy as a whole."*[4]

And describes it further:

> *"Activities may 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*.[5]"

UKSIF firmly believes that good stewardship leads to value creation. As part of an ongoing duty to act in members' interests, IGCs should therefore consider the policy and activity of the insurer and its fund managers in the context of the UK Stewardship Code.

At least one arm of government has already considered the issue; in its response to the Kay Review the Department of Business, Industry and Skills supported stewardship and endorsed Kay's call to broaden the concept. We are therefore disappointed that that thinking is not evidenced in the consultation paper.

3. Environmental, social and governance ("ESG") risks in investment

Environmental, social and governance risks are a group of issues which have clear financial implications for defined contribution asset owners and those representing their interests. An example would be the oil rig explosion suffered by BP in the Gulf of Mexico. It has been argued that poor governance at senior executive and board level allowed a deficient safety culture to develop which made the accident more likely, and the disaster had clear environmental impact. Neither of these governance or environmental factors could be easily modelled the day before the explosion, but that both were financially material became clear very soon after. It is likely that these and other ESG factors will become increasingly important in determining fund total returns in the future. It is vital that decisions on the fund management approach adopted for the funds under the remit of an IGC carefully consider the mechanisms used to mitigate these risks.

[4] https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf page 1 paragraph 1
[5] https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.pdf page 1 paragraph 4

The scale of risk is material. An important example is how future management arrangements can deal with the “carbon bubble”.[6] The carbon bubble is the recognition that if climate warming is to be kept to even 2°C hydro-carbon companies will be unable to burn more than 20% of their stated reserves. The implications of this for hydro-carbon companies are immense, as is also the case for other sectors such as transport and alternative energy suppliers. Hydro-carbon companies represent approximately 10% of world equity market value[7] and 6% of world bond markets,[8] and any loss of value linked to this issue is likely to be a central component of future total returns for savers. IGCs should consider issues such as this as part of their duty to act in members’ interests and this is another area where we would like to see IGCs mirror the role of trustee boards.

This example also highlights a point we discussed when we met. Many default DC schemes may use passive investment vehicles, not least for reason of cost. Some party in the administration has to decide the appropriate index and the regularity of review, and that party must have a longer-term perspective. DC schemes and IGCs will not offer good long-term value to members if, in order to save a few basis points a year, they leave members exposed to market-weighted indices as the carbon bubble strikes. This is not an unqualified endorsement of active management; it is a statement that market inefficiency does exist and IGCs are probably the best party in the defined contribution value chain to consider the implications.

UKSIF views the complexity of coping with ESG risks as one of the most serious challenges facing pension schemes over the next 10-15 years and feels they should be properly considered as part of the IGC risk assessment process.

We hope we have provided enough information about our views, which reflect those of our members, for our answers to be read in context. We now respond to each of the questions in the consultation paper.

[6] http://www.carbontracker.org/site/carbonbubble
[7] http://www.msci.com/resources/factsheets/index_fact_sheet/msci-world-index.pdf retrieved 2/10/14
[8] Personal communication from UKSIF member

Question 1: We would welcome views on the likely equality and diversity impacts of the proposed rules.

It is essential that vulnerable members of the scheme are properly represented. We would like an explanation of how the IGC will ensure that the interests of potentially vulnerable members are represented as well as the procedure for raising concerns. It is often the most vulnerable members of a scheme that will be the least engaged yet the most reliant on good outcomes.

We are concerned at the lack of provision for diversity of committee membership and would like the FCA expand on this. We would like any statement to include information on, for example, how advertising committee vacancies is extended to the widest audience as is reasonable or how IGC meetings are to be arranged at a convenient time and place for all members. We believe a direct consequence of increased diversity is increased effectiveness of the committee.

Requirement to establish an IGC

Question 2: Do you agree that deferred members of workplace personal pension schemes should be within the mandatory scope of IGCs?

Deferred members will often be less engaged since they are no longer contributing and employers may therefore be less incentivised to protect their interests. These members will need protection and the IGC is ideally positioned to offer this. The DWP's estimate that, due to the introduction of Automatic Enrolment, there will be 50 million dormant pots of pension assets by 2050 shows the necessity of protection.

Question 3: Do you agree that individual personal pensions, other than those that originated as workplace personal pensions, should not be in the mandatory scope of IGCs?

Yes.

Question 4: Do you agree that individual personal pensions should not be in the mandatory scope of IGCs even where the employer contributes or facilitates payments?

Yes, however IGCs should have the option to consider these individual personal pensions by extending the terms of reference on a voluntary basis.

Question 5: Do you agree with our proposals for which firms will be required to establish and maintain an IGC?

Yes.

Question 6: Do you agree that IGCs may be established at a group level?

We believe that provided the IGC is appropriately resourced and is supported, proportionately to the number of schemes it is responsible for, a group level IGC can act in the interests of all scheme members in workplace personal pension schemes operated by more than one provider within a group.

Establishing and maintain an IGC

Question 7: Do you agree that an IGC must have a majority of members independent of the firm and that the IGC Chair must always be independent?

The majority of members of the IGC must be independent of the firm and the IGC Chair must always be independent. We appreciate the firm specific, in-depth knowledge employee IGC members can provide, however we are also concerned by the resulting lack of accountability. We therefore propose that a firm may provide a maximum of one employee member to retain the in-depth knowledge of the committee while also maximising the number of independent members.

Question 8: Do you agree that an IGC should have at least five members?

A five member committee strikes a good balance between having a range of views and expertise while keeping expense to the firm at a minimum. Since it is likely that most IGCs will only have the minimum five members, it is essential that the firm only appoints one employee to the committee. We would welcome the opportunity for a place to be taken by a representative of the scheme members. Where necessary, training should be provided by the FCA akin to the TPR's Trustee Toolkit.

Question 9: Do you agree with our proposed definition of independence that would allow trustees of a firm's mastertrust to be independent IGC members?

No, we are concerned about the potential for conflict of interest issues arising from independent members sitting on both the mastertrust and the IGC.

Proposed rules for independent governance committees

Question 10: Do you agree that we should not require firms to indemnify IGC members?

Indemnification of IGC members is something the Law Commission specifically recommends and the justification in the consultation paper for excluding this as a requirement is vague.

Membership of an IGC is a position with considerable responsibility and in our discussion with members and stakeholders it was argued that a lack of indemnification could result in a lack of quality appointments. Many firms are concerned with the small size of the pool from which they can recruit candidates; where indemnification is not offered, individuals may turn down the position thus further reducing the size of the pool and quality of appointments.

In the Government's own publication they make their own views on indemnification clear:

"As well as helping to ensure people are not put off from sitting on IGCs, this would give providers a clear interest in ensuring that the Committees carry out their tasks correctly. We agree with these proposals."[9]

Question 11: Do you agree that members of the IGC, including the IGC Chair, should not be approved persons at this time?

At this point yes, noting with concern that one of the main justifications for this is the tight timetable for introduction.

We want to see the implementation of IGCs following a consultation process where decisions are made with the fundamental objective of securing their long-term effectiveness. This is far harder to achieve when decisions are heavily based on time constraints and this risks the overall success of the initiative.

Question 12: Do you agree that we should require firms to recruit independent IGC members through an open and transparent recruitment process?

The selection process must be open and transparent. We would like to see a requirement that the independent IGC Chair is involved in the selection of IGC members including those representing the firm. A way will have to be found to conform this approach to situations where scheme member representatives are appointed.

Question 13: We would welcome views on the proposed duration of appointment of IGC members.

Terms should be capped, but three years is unlikely to be enough time to ensure effective governance. Fixed terms of no longer than five years, as recommended in the consultation

[9] DWP, *Better workplace pensions: Further measures for savers*, p18
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/298436/better-workplace-pensions-march-2014.pdf

paper, is reasonable, though members' appointments to the IGCs should be staggered to maintain the experience and expertise of the committee. We were somewhat surprised to note at paragraph 3.40, 'it will take time for a new IGC member to become fully effective and, towards the end of the term, the member may have less incentive to challenge the firm if seeking re-appointment.' If this is true of the independent members of the committee then the issue is only magnified when dealing with the firms' employee-appointed members, where it is not just membership of the committee on the line. This adds further credence to the argument for having only one firm representative rather than two.

Question 14: Do you agree that we should permit the appointment of corporate persons to IGCs, including as the IGC Chair?

Corporate persons should be permitted to sit on IGCs, including as IGC Chair, provided the corporate person is independent of the firm and it nominates a named individual to represent them on the committee. We do not think a cap on duration of appointment for a corporate person is necessary, however in the interests of ensuring independence, more information is required on the process for the removal of both the named individual and the corporate person.

Question 15: Do you agree that there should be no restriction on the duration of a corporate appointment?

Yes. However, as time goes by, the corporate firms will compete to win business, which may risk the independence of corporate persons. It is important that the process for the removal of the corporate is transparent to ensure continued independence of the committee, particularly where the corporate is acting as Chair.

Terms of reference for an IGC

Question 16: Do you agree that IGCs should consider in particular the value for money received by individuals enrolled in default funds?

Question 17: Do you agree that, at a minimum, IGCs must assess whether the characteristics and net performance of all investment strategies are regularly reviewed by the firm?

Question 18: Do you agree that, rather than mandating a particular approach, we should allow individual IGCs to determine how best to assess value for money?

We want to ensure that the term 'value for money' is not too narrowly defined. We believe it should represent the long-term net of charges return to members. As such it would tend to drive appropriately long-term investment behaviour. Whilst it is important that IGCs consider costs and charges when determining value for money and explicitly considering the long-term.

We believe there is a need for some guidance surrounding the term 'value for money'. The FCA need not prescribe a certain approach but since the assessment of value for money is one of the main functions of an IGC, guidance which specifically refers to performance over the long-term, responsible investment and stewardship would be extremely useful

As stated above, we are concerned that there is no requirement to consider responsible investment practices or indeed any mention at all of stewardship. This is all the more surprising since the Stewardship Code sets out good practice whereby the value of investments can be protected. Robust independent research has shown that good stewardship and the integration of financially material environmental, social and governance (ESG) factors within investment decisions "may lead to improved risk-adjusted performance, especially in the medium-long term and are likely to provide protection against potential value destruction."[10]

With respect to default funds, NAPF research suggests default funds are likely to account for 83% of all DC assets in 10 years,[11] highlighting the importance of good member outcomes. However, we do not believe default funds alone should receive the highest level of attention. It is unrealistic and unfair for scheme members who, following the conclusions of the Kay Review[12], the Government's response to it[13] as well as the Law Commission recommendations[14], reasonably expect good stewardship of assets to be forced to join a non-default fund and risk incurring higher costs and charges.

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[10] National Association of Pension Funds, *What do pension scheme members expect of how their savings are invested?*, July 2014
http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0334_Default_fund_design_in_DC.pdf

[11] Defined Contribution Investment Forum and National Association of Pension Funds, *Default Fund Design and Governance in DC Pensions*, September 2013
http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0391_what_do_pension_scheme_members_expect_of_how_their_savings_are_invested_an_NAPF_research_report.pdf

[12] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf

[13] https://www.gov.uk/government/consultations/the-kay-review-of-uk-equity-markets-and-long-term-decision-making

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

Question 19: Do you agree that IGCs should be required, at a minimum, to review the three aspects of scheme quality proposed, and should consider other aspects as appropriate?

Yes.

Question 20: Do you agree that IGCs should consider all costs and charges, as proposed? If not, what would you suggest?

Yes. We are concerned about the potential for a water-bed effect where transaction costs are excluded from the charge cap and deducted from funds. This could risk creating inappropriate incentives to trade. This conflicts with the Kay Review which stressed that charging structures should encourage long-term investment over long-term trading. We believe this should be reviewed in 2017.

Question 21: We would welcome views on how best to improve the disclosure of all costs and charges, and how we could transpose the industry standards for authorised funds to pensions.

N/A

Question 22: Do you agree that IGCs should be able to escalate concerns directly to the FCA, alert relevant scheme members and employers, and make their concerns public? Financial Conduct Authority

Yes.

Proposed rules for independent governance committees

Question 23: Do you agree that the IGC Chair should be required to produce an annual report and that the firm should be required to make this report publicly available?

Yes.

Question 24: We would welcome views on where IGCs should focus their attention.

IGCs should focus their attention value for money for members of the scheme. This includes:

- Long-term investment performance which demands attention on responsible investment practices and the integration of ESG considerations.

- Stewardship, as set out in the Stewardship Code.[15]
- Quality of scheme administration.
- Charges and costs.

Ensuring effectiveness of IGCs

Question 25: Do you agree that we should place a duty on the firm to provide the IGC with all information that it reasonably requests for the purposes of carrying out its duties?

Yes. This will include information relating to the scheme and investment administration as well as charges. It will also take account of information relating to the management and investment of pension assets and related costs and charges. Comprised within this information should be evidence, where reasonably requested and relevant, of consideration of stewardship and responsible investment practices.

Question 26: Do you agree that we should place a duty on the firm to provide sufficient resources to the IGC as are reasonably necessary for it to carry out its duties?

Yes. This should cover resources of all kinds; personnel, systems and cash. IGCs of large providers will have responsibility for many billions of pounds of assets. If they have the appropriate terms of reference it is likely they will be among the first UK bodies to identify and have to consider the challenges of sustainability which lie ahead. It would be intolerable if they did not have the necessary financial resources to address and research issues which the provider was not able or willing to consider. In the future the largest IGCs will need to adopt a leadership role if they are to protect their members' interests.

Question 27: We would welcome views on possible arrangements to ensure that member views are directly represented to the IGC.

It is essential that firms make arrangements to ensure relevant scheme member views can be directly represented to IGCs. There should be no interference by the firm as to which views are put forward. This may be through a members' panel similar to NEST or via a representative of scheme members (see Q8). The representative may be a scheme member or a member of a relevant trade union which would eliminate concerns where the firm operates multiple schemes with diverse member groups.

Question 28: Do you agree that the firm should make the IGC's annual report and terms of reference publicly available?

[15] https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx

Yes. Due to the lack of engagement from some default scheme members it should be made clear that this information is available on request and online. The report should contain information relating to good stewardship and responsible investment practices.

Question 29: Do you agree that we should place a duty on the firm to address concerns raised by the IGC or explain to the IGC why it does not intend to do so?

Yes. Any explanations as to why the firm has not addressed a concern or followed a recommendation from an IGC should be included in the annual report of the IGC chair.

Proportionate alternative arrangements

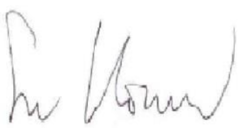
Question 30: Do you agree that GAAs should be allowed as an alternative to IGCs for firms with smaller and less complex workplace personal pension schemes?

Question 31: Do you agree with our proposals for the type of firms that can use GAAs?

We are concerned that as the proposals stand this could lead to a two-tier system. While GAA funds are unlikely to be as large as those of IGCs they will still be responsible for sizeable assets. It is vital GAAs take into consideration good stewardship and responsible investment practices and to enable them to do this they will need to have adequate resources available to them in order to conduct necessary research on behalf of clients. We agree that GAAs should ensure that the mandatory requirements in the terms of reference for IGCs apply.

We trust that our comments will prove to be self-explanatory, but if you would like any further clarification, I hope that you will not hesitate to contact us.

Yours sincerely,



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