UKSIF
UK Sustainable Investment and Finance Association

10 December 2015

Maggie Simpkin
Department for Work and Pensions
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London
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Dear Ms Simpkin,

Thank you for the opportunity to respond to your consultation regarding how schemes make information relating to investments available to beneficiaries. This consultation follows several Government or Government-backed inquiries including the Kay Review,[1] the Law Commission's report into fiduciary duties[2] and subsequent DWP consultation, and a DWP call for evidence on disclosure of transaction costs. Ultimately, these projects have been geared towards reducing short-termism, increasing trust and encouraging transparency throughout the investment chain.

As you know, we were very disappointed by the Government's response to the February inquiry on how to clarify the concept of fiduciary duty. We felt the Government missed a rare opportunity to provide absolute clarity for trustees and their agents and to finally remove misconceptions over any perceived duty to maximise returns. This response is intended to highlight the importance of increasing transparency in the investment chain as such we have answered questions 11, 12 and 13.

UKSIF represents sustainable and responsible investors (SRI) throughout the UK, including institutional investors and asset managers. In March we convened a meeting of UKSIF members to establish the position of the SRI sector with regards to incorporating the Law Commission's findings on fiduciary duties into law. This involved determining three things:

- How trustees evaluate long-term risks, including from financially-material environmental, social and governance (ESG) factors.
- When it is appropriate for trustees to make investment decisions based on non-financial factors.
- How to encourage trustees to consider their approach to stewardship.

In our response[3] we were clear on the aspects that an amended Investment Regulations should take into account to ensure good member outcomes. Much of this involved increased transparency in the investment chain as a driver of responsible investment and is therefore relevant to this consultation. Disclosing the above information is essential to improving

[1] *The Kay Review of UK Equity Markets and Long-term Decision Making,* 2012. Available at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf
[2] Law Commission, *Fiduciary Duties of Investment Intermediaries,* 2014. Available at http://www.lawcom.gov.uk/wp-content/uploads/2015/03/lc350_fiduciary_duties.pdf
[3] Available at http://uksif.org/wp-content/uploads/2015/04/UKSIF-Response-to-OPSR-Consultation.pdf

transparency. Generally in practice however disclosures of this nature are infrequent, inadequate and specific requests for information often result in individuals being directed to the scheme's relevant policy statement.

Q11. To what extent do trustees and scheme managers currently make information on selection, monitoring, retention, stewardship and realisation of investments; and selection, appointment and monitoring of investment managers and other agents available to beneficiaries on request?

We welcomed the findings of the Law Commission's report on fiduciary duties, although we are not satisfied those findings have permeated the sector as a whole. The Law Commission came to the conclusion that trustees *should* take into account long-term financially-material factors including those related to ESG. We feel our response to the February consultation is germane. Based on the Law Commission's findings it remains our view that the following information should be provided by trustees for beneficiaries and others:

- Annually in writing or on their website their procedure for identifying financially-material factors;
- Annually in writing or on their website the advice they revived and their conclusions with regard to such factors;
- On a regular basis how they ensure they are notified of emerging issues so that beneficiaries can be confident that long-term financially-material factors are being taken into account;
- Annually report on how they have instructed their agents with respect to issues identified as relevant now or likely to become relevant; and what those agents have done.

Disclosing this type of information will be key to driving more and better responsible investment practices. Updating this information regularly will also be the most resource-efficient way to notify beneficiaries: taking financially material ESG risks into account should be part of regular portfolio risk management. The Government references statistics from the Pensions and Lifetime Savings Association (PLSA). It suggests the vast majority of funds that responded to its annual survey understand long-term considerations, including ESG factors, are compatible with their fiduciary duty, but that has not been our experience. The result of this exercise must be to raise the bar for laggard funds and managers. It may be worth noting that funds which are not engaged with the latest findings from the Law Commission and which do not take into account long-term financially-material considerations will probably also not engage with the PLSA annual survey.

The Law Commission's findings made clear that trustees may consider non-financial factors provided two tests were met:

1. Trustees have good reason to think that scheme members would share the concern; and
2. The decision should not involve a risk of significant financial detriment to the fund.

The law enables trustees to reflect the beliefs and values of the beneficiaries and organisations they represent. It is clear that for this to be effective information needs to be made available by those running the scheme and in some cases more will need to be done to gauge the views of beneficiaries. A poll or survey of members may or may not be necessary depending on the type of scheme or trust deed, but either way trustees will still be required to apply the two tests above. For this to happen efficiently better communication is required between the pension fund and its managers and beneficiaries.

The regulator has an important role to play both in encouraging transparency and in issuing guidance. There is substantial case law involved in determining whether trustees can take into account non-financial factors and TPR will be required to reflect this and to ensure its guidance incorporates the thinking within the Law Commission report.

Stewardship is an integral part of responsible investment. Good stewardship leads to value creation: It gives rise to a more comprehensive understanding of investee companies, including a better appreciation of their values, strategies and strengths and weaknesses. In general only the biggest institutional investors are able to carry out stewardship activities on their own. Many smaller funds outsource this activity to their managers. It is for this reason we do not believe requiring all pension funds to sign the Stewardship Code[4] would be an effective way to encourage better stewardship. Rather, a more desirable situation is one where trustees state their policy on responsible investment (to include their approach to long-term financially-material factors, investments based on non-financial factors and stewardship) in the statement of investment principles with information on how expectations regarding stewardship is conveyed to managers.

Information on stewardship activity including disclosure of expectations, monitoring and activities is vital and subject to consideration of commercial sensitivities should be made available to scheme members. We have therefore argued that for more effective and meaningful stewardship, trustees should:

- Publish annually in writing or on their website their approach to stewardship;
- Publish annually in writing or on their website how their expectations regarding stewardship are conveyed to their managers;
- Publish annually in writing or on their website a statement regarding the methods by which they monitor the stewardship activities of their agents.
- Publish annually a report outlining, in terms commensurate with commercial sensitivity, the activities carried out on their behalf.

<u>Q.12 What are the challenges trustees and scheme managers might face in accessing this information including how it may be affected by different investment approaches?</u>

Clearly there are some challenges for some trustees and scheme managers in accessing this information in the current system. We do not believe there is yet sufficient market demand to drive more disclosure, however the sector is moving in the right direction. This is one reason why we were particularly disappointed with the fiduciary duty outcome: the opportunity to accelerate this process has been missed. There are two ways to remedy this: a regulatory approach or a market-led solution, but either way, access to this information will probably mean increased

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

costs. We believe distribution of this information is part of good fund management and the costs should therefore be incurred by managers.

With COP21 and agreement on the Sustainable Development Goals both taking pace in 2015, governments have focussed on combatting climate change and promoting sustainable development. Earlier this year the French Government announced new rules[5] geared towards ensuring the French financial services sector properly considers climate risks. Just as in the UK, many pension funds in France have argued that because carbon is a risk, pension funds should both assess and mitigate that risk. Many have already signed the Montreal Pledge[6] which requires them to understand the exposure of their portfolios to carbon risk and implement a decarbonisation strategy. The new Energy Transition Law makes France the first country in the world to require institutional investors to report on carbon exposure.

The requirement is contained within Article 48 and requires institutional investors to disclose in their annual reports:

- Financial risks linked to the effects of climate change;
- Measures adopted to reduce those risks, by implementing a low-carbon strategy; and
- The consequences on climate change of the company's activities.

It also requires institutional investors to disclose in their annual reports and make available to their beneficiaries information on how their investment decision making process takes social, environmental and governance criteria into consideration.

France has the second biggest sustainable and responsible investment market in Europe with an estimated €1.7tn, behind only the UK with an estimated €1.9tn[7]. Clearly it is well placed to introduce such legislation. It is our view that the UK is equally well placed to introduce measures such as this, but if it is the view of the Government that amending the Investment Regulations is not an appropriate way to support this change, then guidance from The Pensions Regulator, that incorporates the sentiment in the new French law and encourages further disclosure, should be introduced as a first step towards better transparency.

There has been further international recognition of the importance of transparency and specifically disclosures relating to financially material information. The Financial Stability Board (FSB)[8] last week announced the creation of the Task Force on Climate-related Financial Disclosure (TCFD) which is geared towards encouraging voluntary, consistent climate-related financial risk disclosure by companies in providing information to investors. Mark Carney, Chair of the FSB, has made clear this information will "allow market participants and policymakers to understand and better manage those risks, which are likely to grow with time". The physical, liability and

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[5] More information available at http://2degrees-investing.org/IMG/pdf/energy_transition_law_in_france_-_briefing_note_final.pdf
[6] http://montrealpledge.org/
[7] Eurosif, *European SRI Study*, 2014 available at http://www.eurosif.org/our-work/research/sri/european-sri-study-2014/
[8] More information at http://www.financialstabilityboard.org/2015/12/fsb-to-establish-task-force-on-climate-related-financial-disclosures/

transitional risks linked to climate change will be considered by the TCFD and it will develop a set of recommendations for "consistent, comparable, reliable, clear and efficient climate-related disclosures". The point of this exercise is to help relocate capital towards more sustainable, environmentally-friendly companies. Rules that encourage UK pension funds to disclosure the above information would help bridge the gap, encourage more companies to disclose climate-related data and represent another step towards a more stable financial system.

Over the past year we have witnessed at least two examples of market-led solutions in the UK attempting to overcome the problem of access to information and encourage more responsible investment. The first, the Pension Fund Roundtable's (PFR) *Guide to Responsible Investment Reporting in Public Equity*, was published in January 2015 and aims to encourage better engagement between pensions funds and their managers. The PFR consists of 16 funds with over £200bn AuM. The funds believe that integration of ESG factors in both decision making and stewardship can improve transparency and accountability and help explain both short and long-term risk and performance in public equity. The document is intended for use by asset owners as an engagement and monitoring tool for current and prospective fund managers. Ultimately, managers' reporting helps to inform investment decision-making and engagement with trustees, scheme beneficiaries and other stakeholders.

The Association of Member Nominated Trustees (AMNT) has raised over the ability of trustees to adopt good governance practices in pooled funds. One market based solution is the Red Line Voting[9] initiative launched by the AMNT this month. The initiative aims to make it easier for asset owners to adopt active governance of their schemes in includes voting instructions linked to ESG issues. Following the Government's decision not to embed its findings in law, the initiative allows engaged and responsible asset owners to respond to the conclusions of the Law Commission i.e. that trustees *should* take into account all financially material factors.

Clearly the above applies most specifically to equity investment, but where appropriate trustees will consider the need to diversify their investments. Market based solutions for other investment approaches have been limited, suggesting there could be a role for the Government and regulators to play. One example may be climate-conscious asset owners investing in the green bonds market. One of the defining characteristics of a green bond is its use of proceeds. The Green Bond Principles made clear that in general the issuer should declare eligible green project categories which may include[10]:

- Renewable energy
- Energy efficiency (including efficient buildings)
- Sustainable waste management
- Sustainable land use (including sustainable forestry and agriculture)
- Biodiversity conservation
- Clean transportation

[9] More information at http://amnt.org/red-line-voting/
[10] http://www.ceres.org/resources/reports/green-bond-principles-2014-voluntary-process-guidelines-for-issuing-green-bonds

- Clean water and/or drinking water

We believe it is important that where trustees or scheme managers have invested in green bonds, information is available to beneficiaries on projects that have resulted from bond proceeds (annually in writing or on the scheme's website). This information will need to be regularly updated, both to ensure the proceeds are still appropriately managed (i.e. the project is still 'green') and to reflect further project developments. Issuers should report at least annually on investments made from proceeds so the challenge to trustees and scheme managers of reporting this information should be minimal. In any case, this is about good stewardship of assets and information should be made available.

Q13. Do you have any information on the costs involved in disclosing this information to beneficiaries where such information is requested?

Transparency is a key driver for responsible investment and integration of ESG factors. Different trustees and fund managers will have different starting positions; better governance and stewardship will inevitably result in some costs relative to those starting positions. The PFR *Guide to Responsible Investment* states very clearly,

'The long-term benefits that stem from greater transparency and accountability will outweigh any short term incremental reporting costs. Fund managers with high quality responsible investment reporting may be less likely to receive more bespoke reporting requests'.

In other words the bulk of any costs will tend to be incurred by laggard funds; those already doing responsible investment will probably bear less of the burden.

Responsible investment i.e. ESG integration and stewardship has financial benefits. Responsible investment practices, including transparency and disclosure, should be central to asset owners' investment policies and fund managers' investment strategies. In its initial consultation document the Law Commission cited two publications[11] on the financial impact of ESG. The reports, by Deutsche Bank Group and Mercer Investment Consulting and the UN Asset Management Working group, concluded that consideration of ESG factors has a positive financial impact and that the argument that ESG integration will lead to underperformance "simply cannot be made". Please refer to our previous submission for further information.[12]

A separate 2014 report,[13] which represents one of the most comprehensive bodies of research on sustainability in global finance has also made clear the wide ranging benefits from sustainability and ESG integration. Authored by the Smith School of Enterprise and the Environment, University of Oxford and Arabesque Partners the report concludes:

[11] Law Commission, *Fiduciary Duties of Investment Intermediaries,* 2014. Available at http://lawcommission.justice.gov.uk/docs/cp215_fiduciary_duties.pdf 10.50 and 10.51
[12] Available at http://uksif.org/wp-content/uploads/2015/04/UKSIF-Response-to-OPSR-Consultation.pdf
[13] Smith School and Arabesque Partners, *From the Stockholder to the Stakeholder*, 2014. Available at http://www.arabesque.com/index.php?tt_down=51e2de00a30f88872897824d3e211b11

- It is in the best interest of institutional investors and trustees, in order to fulfil their fiduciary duties, to require the inclusion of sustainability parameters into the overall investment process.
- Investors should be active owners and exert their influence on the management of their invested companies to improve the management of sustainability parameters that are most relevant to operational and investment performance.
- It is in the best interest of asset management companies to integrate sustainability parameters into the investment process to deliver competitive risk-adjusted performance over the medium to longer-term and to fulfil their fiduciary duty towards their investors.
- The future of active ownership will most likely be one where multiple stakeholders (such as individual investors and consumers) are involved in setting the agenda for the active ownership strategy of institutional investors.
- Financial benefits of increased sustainability include:
    - 90% of the cost of capital studies for the report show that sound ESG standards lower the cost of capital.
    - 88% of the studies show that solid ESG practices result in better operational performance.
    - 80% of the studies show that stock price performance is positively influenced by good sustainability practices.
- There is a need for ongoing research to identify which sustainability parameters are the most relevant for operational performance and investment returns.

It is due to the experience of UKSIF members as well as the extensive research referred to that we believe that increased use of responsible investment approaches – which will be driven by improved transparency throughout the investment chain – will increase net-of-costs returns. This will occur even where some fees rise to reflect greater resources being applied to responsible fund management as outlined in the Arabesque report.

<u>The transition to DC pensions</u>

Auto-enrolment means there will be 9 million more people with savings by 2020, albeit in defined-contribution schemes. Many of these individuals will have beliefs and values they wish to be reflected in their investments. For example, during Good Money Week UKSIF commissioned research which found that 51% of 18-24 year olds wanted their investments to minimise damage to the environment. The figure for 25-34 and 35-44 year olds on the same issue is 47% and 49% respectively. Values like this cannot be ignored by providers and the market and products will begin to adapt to reflect this.

The Governor of the Bank of England spoke about climate change risk in September[14] and specifically risks arising from "stranded assets"[15]. Savers in DC schemes bear the entire risk of the investment so it is only right they should have more information on the investment policy of their provider and how the scheme is governed. We welcome a focus on better governance but believe

[14] Speech available at http://www.bankofengland.co.uk/publications/Pages/speeches/2015/844.aspx
[15] More information available at http://www.carbontracker.org/report/wasted-capital-and-stranded-assets/

that any progress made on increasing transparency in trust-based schemes should also be reflected in contract-based schemes: they are the future of pensions in the UK. We want to see good member outcomes in both contract and trust-based pensions but this will not be achieved through an inconsistent approach to scheme governance.

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

Yours sincerely,

Simon Howard
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The UK Sustainable Investment and Finance Association (UKSIF)