UKSIF Response to The Pensions Regulator's Draft DC Code of Practice – January 2015

Investment Governance

This section covers default arrangements, documenting investment matters, setting investment objectives and a default strategy, monitoring and reviewing the default strategy, reviewing investment fund performance, and security and liquidity of scheme assets.

The introduction of flexible access to benefits and the new requirements on trustee boards in respect of default arrangements in relevant schemes have placed an even greater emphasis on investment governance.

In relation to the pension flexibilities, the new code highlights the importance of member engagement when setting investment objectives and strategies in paragraph 102.

Is this standard clearly defined?

Yes.

Please give your reasons.

New flexible access to pension pots following the introduction of pension freedoms represents one significant reason to focus on investment governance. More fundamental, however, is the need to move away from a system of "short-termism" in UK equity markets - something which was identified in the Kay Review and by the Law Commission as having led to increased costs, misaligned incentives and reduced trust throughout the investment chain.

Paragraph 101 rightly lays out TPR's expectation that trustee boards take account of risks affecting the long-term financial sustainability of investments. One major issue is that some trustees are not aware that environmental, social and governance (ESG) factors can represent financially material risks. This is a key reason the Law Commission recommended the Government should amend the Investment Regulations to provide absolute clarity for trustees. Since the Government has decided it will not amend the regulations TPR should ensure the term ESG is included in the section on investment governance. While we welcome TPR's stated intention to include reference to the Law Commission's work on fiduciary duties in the 'how to' guidance, making an explicit reference to ESG as a group of factors that should be considered in the Code of Practice and then expanding on that in the subsequent guidance represents the most effective way of providing absolute clarity to trustees while ensuring the Code itself remains as concise as possible.

While the focus on member engagement during the process to set investment objectives is very welcome, there is no detail on how TPR expects trustees to carry out this duty. It is also unclear how frequently trustees are expected to engage on these issues. Further information on TPR's expectations (including examples of best practice) would be welcome in the guidance.

Paragraph 102 also references trustee boards considering matters relating to scheme members' preferences for particular approaches to investment. We would also expect the guidance to reflect the thinking of the Law Commission that investment based on non-financial factors is permissible. This contrasts with financially material factors which trustees *should* take into account. The Law Commission said that non-financial factors may be taken into account provided the following two tests are met:

1. trustees should 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.

We believe reference to the fact that non-financial factors may be taken into account should be included in paragraph 102 and circumstances where this is appropriate should then be expanded on in further guidance. Stewardship is also a vital part of responsible investment, although we appreciate TPR has referenced it in the section on Administration. We would expect to see further information on expectations in the 'how to' guidance.

In our view TPR should explicitly recognise that trustees *should* take into account all financially material factors including ESG and may under certain circumstances take into account non-financial factors and then expand on what that means in guidance.

Are you aware of any barriers that exist in relation to meeting this standard?

One significant barrier is a perception by some trustees that their duty is solely to maximise financial returns rather than consider wider factors including those relevant to long-term investment performance which might not have an immediate financial impact or the ethical views of beneficiaries even where this may not be in the immediate financial interests of those beneficiaries. This may even conflict with the objectives of the fund. One recent example is Surry County Council which has a commitment to reduce the number of smokers in Surrey. Despite this, a freedom of information request showed it owned shares in British American Tobacco. In response, the council stated "our pension investments are completely separate and are managed independently with a focus of achieving a maximum return". A focus on returns at all costs is not a good investment strategy and to suggest that investment is distinct from wider considerations or the fund's own stated objectives is wrong.

It is worth noting that UKSIF commissioned polling for Good Money Week 2015 showed that 50% of people wanted something in addition (a positive social outcome or investments that minimised damage to the environment) to financial returns from their investments.

The law requires trustees to give due consideration to asset protection. However, we recognise the difficulties that trustees experience when trying to establish the extent to which scheme assets are covered by compensation schemes such as the Financial Services Compensation Scheme. The new code sets out our approach to this issue in paragraph 112.

Does this standard convey clearly the regulator's intention that trustees should focus on ensuring they have an understanding of the overall security of scheme assets and on communicating that broad view to members?

Yes.

Please give your reasons.

If by asset protection TPR is specifically referring to how a scheme gains compensation due to insolvency of a firm then TPR's expectations are clear. We would argue that strategies which integrate ESG factors may help trustee boards meet the requirement of the law in regulation 4(3) Occupational Pension Scheme (Investment) Regulations 2005 to ensure at least the security, quality and profitability of the portfolio as a whole. A scheme that takes good governance into account and has a policy and strong record (possibly through its agents) on stewardship ceteris paribus will be less likely to have invested in firms with a significant risk of becoming insolvent.

An investment strategy which incorporates ESG factors into the decision making process helps to mitigate risks. One clear example is the recent Volkswagen scandal which had a significantly detrimental impact on the share price - reducing it by more than 30%. It is worth noting that several research providers had flagged VW governance failings in the months preceding the scandal. For those investors who factored ESG concerns into their investment processes, relative losses were reduced or non-existent.

The Paris Agreement at the COP21 climate change negotiations means we have to limit global average temperatures to 'well under 2 degrees Celsius'. To achieve this we know we will have to be far less reliant on energy from fossil fuels in the future and the price of coal and oil has dropped significantly in recent years. This is a long-term ESG consideration that is clearly financially material and investors that have not considered this as they have developed their investment strategy have already lost out. Investors that continue to consider this as financially immaterial will lose out further. Overall security of scheme assets can be improved through ESG integration. We believe that while TPR is right to require trustees to consider the extent to which FSCS or other compensation or insurance schemes might cover losses to their assets, there is not enough focus on helping trustee boards to avoid those losses in the first place.

Given the new requirements relating to default arrangements, it's important that schemes are able to identify any such arrangements. In particular, this might prove difficult where there has been a change made to the arrangement that member contributions are paid into without the relevant members having been consulted. We have addressed this issue in the new code in paragraph 115.

Do you agree with the regulator's approach to this issue?

Yes.

Please give your reasons.

It is important that trustees consider whether for scheme members who have expressed a choice in the past about where their contributions are invested, but whose contributions are now being paid into a different arrangement without having made a new choice, the original choice extends to the new arrangement. Where this is not the default arrangement trustees should consider whether members have been told about the new arrangement and given the option to stay in the current arrangement or choose an alternative. We would expect trustees to include information relating to the relative benefits of the default arrangement including on charge caps.

Trustees should also be expected to understand and focus on long-term net of fees return. Over the long-term a portfolio managed with an investment policy which incorporates ESG factors and has a policy on stewardship may well have a higher return net of costs and charges than a default arrangement with a charge cap. To cite just one example; a charge capped fund invested in a market capitalisation weighted passive fund will be exposed to the full investment impact of the probable post-COP 21 weakness in carbon-related asset values. That will be a significant drag on net performance compared to a fund that is either actively managed or tracks an index which reflects ESG risks even if the fee for that fund exceeds the charge cap.

In view of the new requirements relating to default arrangements, we have endeavoured to make clear which of those requirements are additional to those relating to investment arrangements generally.

Taking this section in the new code as a whole, do you believe the regulator has articulated clearly the additional legal requirements that relate to default arrangements?

Yes

Please give your reasons.

N/A

The themes set out below are those we have identified that may benefit from more detailed guidance being included in the supporting 'how to' guidance for this section of the new code:

- **Identifying a default arrangement, including default mapping.**
- **Setting a default strategy for decumulation.**
- **Trustee role in selecting investment options.**
- **Target date funds and life-styling approaches to investment strategies.**
- **Processes and triggers for reviewing and monitoring fund performance, including switching.**
- **Using investment powers in the best interests of beneficiaries.**
- **Processes for monitoring membership profile.**
- **Establishing the extent of asset protection.**

Are these the right areas to be covered in guidance?

Yes

Are there any additional areas the regulator should consider covering?

We have already stated our view here and in person that it is essential that TPR makes it explicit that trustees *should* take into account all financially material factors including ESG and *may* take non-financial considerations into account in the Code itself and subsequently expand on what that means in the 'how to' guidance.

Some trustees remain under the misapprehension either that their role is solely to maximise returns at the expense of wider considerations or that some factors, for example climate related risk, is an ethical factor and so they do not have to consider it. Alternatively we have known some trustees to be under the impression that they simply cannot take into account non-financial or ethical factors, which is incorrect.

This is understandable- the case law on this topic is vast and complex which is why we are calling for explicit statements outlining trustees' duties in the Code, with more detailed follow-up information in the 'how to' guidance.