UKSIF
UK Sustainable Investment and Finance Association

Policy update: New Investment Guidance for Defined Benefit Pension Schemes

What has happened?

The Pensions Regulator (TPR) has today (30th March) introduced new investment guidance for trustees of defined-benefit (DB) pension schemes[1]. This publication is in-line with TPR's guidance for trustees of defined-contribution (DC) schemes which was introduced last summer as part of the DC code of practice revision.[2]

How does this relate to responsible investment?

The new guidance is an accurate reflection of the law in the UK and aligns with the Law Commission's findings in its 2014 report into the fiduciary duties of investment intermediaries. The Law Commission found significant confusion amongst trustees on which factors were financially material, which were non-financial, and which factors they should or may take into account. The new guidance helps clarify the regulator's expectation of DB trustees and levels the playing field for trustees of all pension schemes.

Following the publication of the new DC code of practice in 2016, TPR Executive Director of Policy, Andrew Warwick-Thompson, stated "with regards to ESG our guidance is clear that we expect [DC] trustees to take ESG issues into account when assessing portfolios over the long term." The extension of guidance to trustees of DB schemes was the logical next step, and we are thrilled to see our efforts in engaging with policy makers, legal experts and regulators have paid off with consistent guidance for trustees of all schemes.

What does the investment guidance say?

Financial and non-financial factors

In Section 2: Investing to fund defined benefits the guidance comments on financial and non-financial factors and is very clear:

'What you need to do: Take environmental, social and governance factors into account if you believe they're financially significant'.

TPR also summarise the Law Commission's 2014 report into fiduciary duties:

The Law Commission has produced guidance on the legal obligations trustees have when considering financial and non-financial factors when making investment decisions. In summary:

- *You are required to take into account factors that are financially material to investment performance.*
- *You may take into account financial factors which are not financially material to the scheme.*

[1] The new DB guidance is available at http://www.thepensionsregulator.gov.uk/guidance/db-investment.aspx
[2] TPR's investment governance guidance for DC schemes is available at http://www.thepensionsregulator.gov.uk/trustees/investment-management-in-your-dc-scheme.aspx

- *Where you think environmental, social and governance (ESG) factors or ethical issues are financially material, you should take these into account. Likewise if you think certain ethical issues are financially material.*
- *While a financial return should be your main concern, the law is sufficiently flexible to allow you to take other, non-financial factors into account. This may be the case if you have good reason to think scheme members share your view and there is no risk of material financial detriment to the fund.*

You can find the Law Commission guidance at the following link:

https://www.lawcom.gov.uk/wpcontent/uploads/2015/03/lc350_fiduciary_duties_guidance.pdf

To illustrate the guidance on incorporate of financial and non-financial factors, TPR gives two examples as well as two learning points:

Learning Point: Considering financial factors.

Many factors can impact investments over the long-term. Where you consider these to be financially material, you are required by law to factor them into your investment decision-making.

Learning Point: Considering non-financial factors.

You may take non-financial factors into account if you have good reason to consider the membership holds a similar view and you are satisfied that the investment does not present a risk of material financial detriment.

Investing for the long-term

TPR has recognised the long-term nature of pension scheme investing and offered guidance to trustees on financial risks over the long-term:

Most investments in pension schemes are long-term and are therefore exposed to long-term financial risks. These potentially include risks relating to factors such as climate change, unsustainable business practices, and unsound corporate governance. Despite the long-term nature of investments, these risks could be financially significant, both over the short and longer term.

You should therefore decide how relevant these factors are to inform your investment strategy. You could ask your investment manager(s) and investment adviser for help with this.

The document also defines sustainability/sustainable investment as *'meeting present and future needs through the management of long-term risks and opportunities, which involves considering ESG issues and wider societal impacts.'*

Stewardship

The guidance is clear that investment governance includes stewardship activities. Where trustees have not developed their own policies on stewardship, they are encouraged to *'to become familiar with your managers' policies and, where appropriate, seek to influence them'.*

The section on investment stewardship goes into more detail on the regulator's expectations, including:

- *Recognition that stewardship activities are likely to be carried out by the fund manager on the trustee board's behalf- which is especially the case for pooled funds.*
- *Becoming familiar with the stewardship policies of existing or prospective investment managers and where appropriate seek to influence them.*
- *That for some schemes a formal scheme stewardship approach may be appropriate (e.g. by following the principles set out in the Stewardship Code).*

The regulator comments that good stewardship *'includes the exercising of rights attaching to investment, such as voting rights attached to shares. Where practicable, you may wish to agree specific voting criteria with your investment managers or consider potential managers' willingness to abide by your preferred voting criteria when selecting investment managers. Services that provide analysis and voting recommendations are available and can assist you in setting criteria.'*

The regulator also notes that scheme SIP is required to include statements about policies (if any) on voting rights and the extent to which ethical considerations are taken into account in the investment process. It suggests trustees '*may wish to expand these statements into meaningful policies on long-term sustainability, how the principles of the Stewardship Code are applied and how non-financial factors will be taken into account.'*

Finally, the guidance recommends that while reviewing manager performance, *'trustees should evaluate the manager's actions regarding ESG factors and shareholder engagement.'*

What role has UKSIF played?

UKSIF was influential in emphasising the importance of responsible investment to the Law Commission in 2014 and has engaged extensively with The Pensions Regulator over the past eighteen months. Our engagements have focused on both the DC code of practice revision and more recently the DB investment guidance.

In November, Chief Executive of The Pensions Regulator, Lesley Titcomb spoke at the UKSIF Annual Lecture. In particular she highlighted the financial relevant of ESG factors to pension schemes and of her concern that some trustees "don't have ESG on their agendas". We are confident this revision to investment guidance for DB trustees will help rectify that situation.

Next steps?

The Pensions Regulator is interested in hearing how the new guidance will be used by trustees, advisers and employers. UKSIF would also be happy to pass on any questions or comments directly to TPR.