UKSIF
UK Sustainable Investment and Finance Association

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Dear Mr Doyle,

I am writing to you in my capacity as Chief Executive of the UK Sustainable Investment and Finance Association in response to your recent consultation on the Pension Quality Mark (PQM), PQM Plus and PQM Ready accreditation schemes.

This consultation is timely. Momentum in encouraging better and more responsible ways of investment and finance has been building over recent years and PQM has the opportunity to build on these recent developments. Our response focuses specifically on questions 15-16 and 31-32 which reflect these developments, but first it is important to outline the clear direction of travel towards responsible investment in both the UK and in Europe.

We believe it is a matter of when, not if, rules requiring schemes to be more transparent on these issues are introduced and this is evidence below. PQM has an early opportunity to shape the way in which this information is reported and to promote the highest standards of ESG and stewardship disclosures for DC schemes in the UK.

1. The Law Commission's 2014 report on fiduciary duties

In 2014 the Law Commission published a wide-ranging report into the fiduciary duties of investment intermediaries.[1] It concluded that as the law stood pension fund trustees *should* take into account all financially material factors, including those arising from ESG issues. These differ from "ethical" or non-financial factors, because they have a material impact on the performance of an investment.

The Law Commission also found that while financial return should be the trustees' predominant concern, the law is sufficiently flexible to allow other non-financial factors to be taken into account in certain circumstances, provided that:

(1) They have good reason to think that scheme members share the concern; and
(2) There is no risk of financial detriment to the fund.

The Law Commission recommended that the Occupational Pension Scheme (Investment) Regulations 2005 ("Investment Regulations") be amended to better reflect the difference between financial and non-financial factors. The existing language – which refers to social, ethical and environmental "SEE" factors – was found to have added unnecessary confusion for trustees over

[1] Law Commission, Fiduciary Duties of Investment Intermediaries, 2014 available at http://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/

which factors should be considered when making investment decisions. The conflation between social and environmental factors, which may be financially material, and ethical factors, which are non-financial can lead to both a failure to consider long-term risks and opportunities and the concerns of beneficiaries.

Despite this in November 2015, even with 43 of 45 respondents calling for changes via the subsequent public consultation, the Department for Work and Pensions refused to amend the Investment Regulations, citing a "lack of consensus on how this might best be done".

2. The Local Government Pension Scheme

In September 2016, the Department for Communities and Local Government published new rules and guidance which reflected the Law Commission's thinking. The previous requirement to produce a Statement of Investment Principles (SIP) was replaced to require administering authorities to produce an Investment Strategy Statement (ISS). We welcomed this development, particularly Regulation 7(2)(e) which requires the ISS to contain information on how ESG considerations are taken into account in the selection, non-selection, retention and realisation of investments. The guidance also states that:

> *'The law is generally clear that schemes should consider any factors that are financially material to the performance of their investments, including social, environmental and corporate governance factors.'*

We also welcomed Regulation 7(2)(f) which requires administering authorities to state their policy on the exercise of rights (including voting rights) attaching to investments. However the guidance is clear that these rights are not limited to voting and it comments on the long-term benefits of effective stewardship and company engagement:

> '*Stewardship aims to promote the long term success of companies in such a way that the ultimate providers of capital also prosper. Stewardship activities include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure and corporate governance, including culture and remuneration…Engagement enables administering authorities as long term shareholders to exert a positive influence on companies to promote strong governance, manage risk, increase accountability and drive improvements in the management of environmental, social and corporate governance issues.'*

These new rules entered into force in April 2017.

3. The Pensions Regulator

UKSIF has worked closely with The Pensions Regulator (TPR) as it developed new investment governance guidance for trustees of both defined-benefit (DB) and defined-contribution (DC) pension schemes. We strongly welcomed TPR's focus on ESG issues, whose views were summed up by the then Director of Regulation, Andrew Warwick-Thompson, in September 2016:

> *"With regards to ESG our guidance is clear that we expect trustees to take ESG issues into account when assessing portfolios over the long term. It is also worth noting that if the revised Institutions for Occupational Retirement Provision directive (IORP II) comes into effect then it will be a legal requirement that trustees take these issues into account. I would urge any trustee or asset manager out there who still thinks these things don't matter to wake up and smell the coffee. We need to guard against complacency here."*[2]

These views are clearly reflected in the new investment governance guidance for all trust-based schemes which also align closely with the Law Commission's 2014 report. TPR is clear:

> *'You are required to take into account factors that are financially material to investment performance'* and *'What you need to do: Take environmental, social and governance factors into account if you believe they're financially significant'.*

With regards to long-term investing and stewardship, TPR says:

> *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.*

4. The Law Commission's 2017 report on pension funds and social investments

Last month the Law Commission published another report on pension funds and social investments. It again recommends statutory and regulatory changes to clarify the law for investors and boost long-term, responsible investment in the UK. The report updates proposals which the Government failed to implement during the last Parliament, specifically that pension schemes should report on their approach to ESG, ethical investment and stewardship of investments and that the FCA publish guidance for relevant schemes on these approaches.

[2] Andrew Warwick-Thompson, September 2016: https://www.professionalpensions.com/professional-pensions/news/2470190/tpr-trustees-must-wake-up-and-smell-the-coffee-on-esg

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UKSIF Response to the PQM consultation

The legal formation of trust-based DC pension schemes has no bearing on overall performance; this is driven by the investment strategy. The integration of ESG factors during the investment process and subsequent to it via engagement and stewardship actively create value and evidence for this continues to grow.[3] Our response takes questions 15 and 31, and 16 and 32 together.

Q15 and Q31: Should schemes be required to:

a) **Publish**
b) **Disseminate to members; and**
c) **Submit for PQM accreditation a stewardship statement of their approach to corporate governance and ESG? Should this statement be reviewed annually or with some other appropriate frequency? Should boards be required to provide evidence their stewardship statements' principles are represented in their default fund options and that they monitor their fund managers' compliance with their schemes' stewardship statements?**

UKSIF strongly supports proposals for schemes to make public their approaches to ESG and stewardship. While we welcome PQM's statement at 2.18 of the consultation document that 'corporate stewardship is an important aspect of long-term asset ownership', we would direct your attention to the most recent Law Commission report, summed up in Paragraph 4. The Law Commission state:

> *'By stewardship, we mean how trustees will promote an investment's long-term success, through monitoring, engagement or voting, either directly or through their investment managers. In this context, an investment could be equities (shares) in a company, but it could also be investment in an alternative asset class, for example in relation to an infrastructure project.'*[4]

The Law Commission is saying that stewardship doesn't just apply to equities but across all asset classes. Increasingly we are seeing new and innovative ways of investing responsibly often in illiquid assets such as green bonds, infrastructure and social investment. To reflect this, Recommendation 1 (which is mirrored in Recommendation 3 for contract-based schemes) of the Law Commission's report is almost identical to its original 2014 recommendation, but has been updated to replace 'evaluating risks to a *company* over the long-term' and now reads:

> *'Regulation 2(3)(b)(vi) of the Occupational Pension Schemes (Investment) Regulations 2005 should be amended to require trustees to state their policies in relation to:*

[3] Oxford University, From the Stockholder to the Stakeholder: How sustainability can drive financial outperformance, 2015, available at https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf
[4] Law Commission, Pension Funds and Social Investment, 6.25 available at http://www.lawcom.gov.uk/app/uploads/2017/06/Final-report-Pension-funds-and-socia....pdf

(1) ***evaluating risks to an investment in the long term****, including risks relating to sustainability arising* from corporate governance or from environmental or social impact;

(2) considering and responding to members' ethical and other concerns'

UKSIF believes it is important that PQM's new criteria also reflect emerging trends and ensure they do not restrict, but rather encourage, trustees to engage with and promote good stewardship activities across all asset classes, not just equities. There is a renewed focus by Government on the promotion of long-term investment which captures the "illiquidity premium" – something DC schemes with their long-term time horizons are well placed to "cash in" on. This can have a real boost in improving member outcomes.

We believe that transparency is a vital cog in rebuilding trust that was lost during the financial crisis. Therefore we strongly support the proposal that schemes publish their approach to ESG and stewardship. In any case we would expect schemes wishing to attain accreditation from PQM to have signed the Stewardship Code. It is worth noting that this is already the guidance for all trustees following TPR's new investment governance guidance for DB and DC schemes and is now current practice for LGPS funds following the introduction of new rules, as outlined in Paragraph 2.

We would welcome policies on corporate governance and stewardship being submitted to PQM during the application process. We also support regular reviews by PQM on this, and while we do not seek to proscribe a length of time between each review it should be at least once every three years – in line with the requirement to review the scheme's SIP. Evidence that boards are taking this seriously would be welcome.

Q16 and Q32: Should boards

- **a) Publish;**
- **b) Disseminate to members;**
- **c) Submit for PQM accreditation diversity statements and submit further evidence they meet the standards set by their diversity statements?**

UKSIF strongly supports the publication of statements on diversity for both the board and sub-committees, which should be submitted for PQM accreditation. We agree with the sentiment that where PQM-eligible schemes require high governance standards of the companies in which they invest – and throughout all their investments – they should also have similar standards of internal governance. As asset owners they set the tone for their investments and should set an example to others down the investment chain.

In the Corporate Governance Code, the Financial Reporting Council (FRC) outline the benefits of diversity on boards:

> *Essential to the effective functioning of any board is dialogue which is both constructive and challenging. The problems arising from "groupthink" have been exposed in particular as a result of the financial crisis. One of the ways in which constructive debate can be encouraged is through having sufficient diversity on the board. This includes, but is not limited to, gender and race. Diverse board composition in these respects is not on its own a guarantee. Diversity*

is as much about differences of approach and experience, and it is very important in ensuring effective engagement with key stakeholders and in order to deliver the business strategy.

The diversity statement should be reviewed on a regular basis and be in-line with the principles of the Corporate Governance Code. Again, we do not intend to proscribe the frequency by which this is done, but it would make sense for it to be reviewed alongside the ESG and corporate governance statements and in any case once every three years at least.

We would be more than happy to meet to discuss this issue further. Alternatively, if you have any questions at all please do not hesitate to contact me via fergus.moffatt@uksif.org.

Yours sincerely

Simon Howard
Chief Executive
UK Sustainable Investment and Finance Association (UKSIF)