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UK Sustainable Investment and Finance Association

Policy update: Government response to the Law Commission report on pension funds and social investment.

What has happened?

The Department for Work and Pensions (DWP), the Department for Digital, Culture, Media and Sport (DCMS) and the Financial Conduct Authority (FCA) have today (18th June) published a joint response to the Law Commission's 2017 report on pension funds and social investment.

How does this relate to responsible investment?

The Law Commission's report made a range of policy recommendations to DWP and FCA, in particular on the need to clarify fiduciary duty both for trust-based and contract-based pension schemes, as well as various 'options for reform' to boost the ability of schemes to do social investment.

The joint ministerial foreword is written by Guy Opperman MP, Minister for Pensions and Financial Inclusion, and Tracey Crouch MP, Minister for Sport and Civil Society. It notes the Government's intention to take forward the Law Commission's recommendations and announces a consultation from DWP on trust-based pensions with a view to implementing the changes by October 2019. Specifically this will mean a change to the law to require trustees 'to consider the impacts on their investments from a changing environment, corporate governance and social trends'. In addition, trustees will be expected to have a policy on how they take account of members' view, such as on social impact. In an equally significant move, the FCA has also announced it will also take forward and build upon the recommendations for contract-based pension schemes, by consulting on rule changes for Independent Governance Committees (IGCs).

The Government's response

The Law Commission's policy recommendations were aimed both at the Government and the FCA. The Government has therefore responded to recommendations 1 and 2, while the FCA responded to recommendations 3, 4 and 5. This member briefing focusses on the Government and FCA's response to these recommendations, rather than the separate 'options for reform'.

Recommendation 1

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:

(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; and

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

The Government notes that in its interim response in December 2017, it confirmed its intention to consult on this recommendation in full, and stated that it was minded to make the change. This remains the case, and the Government notes the consultation which has been published on changes to the Occupational Pension Schemes (Investment and Disclosure) Amendment Regulations.

This will require trustees of schemes with more than 100 members to:

- State their policies in relation to financially material considerations, including but not limited to 'ESG considerations (including climate change)'
- State the extent to which the views held by members of the scheme (including but not not limited to, views on ethical, social impact and present and future quality of life matters) are taken into account.

Recommendation 2

(1) Regulation 2(3)(c) of the Occupational Pension Schemes (Investment) Regulations 2005 should be amended to require the Statement of Investment Principles (SIP) to state trustees' policy (if any) on stewardship. Stewardship would include the exercise of formal rights (such as voting) and more informal methods of engagement.

(2) This requirement should apply to both the SIP prepared under regulation 2 and regulation 2A.

The Government has stated that the consultation and draft regulations propose to require only schemes with more than 100 members to set out their policy on:

- The exercise of the rights (including voting rights) attaching to the investments; and
- Undertaking engagement activities, including how and when trustees monitor and engage with: the firms in which they invest; people who manage the investments on their behalf; and fellow investors.

Recommendation 3

We recommend that COBS 19.5 should be amended to require IGCs to report on the firm's policies in relation to:

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

(2) considering and responding to members' ethical and other concerns. This requirement should apply to policies reflected in investment strategies including default investment strategies.

The FCA notes growing interest in the role of financial regulators and the financial services sector in responding to sustainability risks including from climate change and the long-term harm it can cause. It goes on to note the role of IGCs which were introduced as part of a range of protections to boost value for money for members. (NB the FCA says "IGCs have a similar role to trustee boards" and they are a key way for the sector to influence into contract-based schemes.) It agrees that mandating reporting on how firms integrate ESG factors in decision making could promote greater transparency across providers and better enable engagement on such issues. It argues that this could lead to increased competition between providers to design and monitor investment strategies incorporating ESG factors and protect consumers from potentially unsuitable investments.

The FCA notes the recently published European Commission Action Plan on Financing Sustainable Growth has as an objective the management of financial risks stemming from climate change, environmental degradation and social issues. It also notes the risk that some providers could be driven towards making ethical or social impact investments which are unsuitable for members, yet accepts that understanding the concerns of those members is important.

It notes that ESG considerations can represent both risks and opportunity and argues that other risks such as interest rate, inflation, liquidity, concentration, exchange rate, political and counterparty risks should be considered. As such the FCA has committed to consul on a broader rule change than the one proposed by the Law Commission. Specifically that 'IGCs must report on their firm's policy on evaluating financially material considerations, including but not limited to ESG considerations, including climate change.' It will also consult on a requirement for IGCs to report on how the provider considers members' concerns.

However, given other work underway which the FCA argues may require further rule changes for IGCs, it intends to wait until the conclusion of that work and to consult on a 'single package of rule changes' in Q1 2019.

Recommendation 4

We also recommend that COBS 19.5 should be amended to require IGCs to report on the firm's policy (if any) on stewardship. This requirement should apply to the policy reflected in investment strategies including default investment strategies.

The FCA notes the European Commission's revised Shareholder Rights Directive (SRD2), which is due to be implemented by 10th June 2019. It argues that, if implemented, it will impose general comply or explain requirements on providers to disclose their engagement policy, including how they monitor investee companies on financial and non-financial risks, social and environmental impact and corporate governance.

The FCA argue that this requirement would make it more likely that insurers would have a stewardship policy on which IGCs could report. It considers that the Law Commission's recommendation would promote transparency and encourage providers to engage with fund managers and investee companies. Since the FCA does not see any need to wait for SRD2 to introduce such a requirement, it will consult on a rule change to similar effect to that proposed by the Law Commission as part of the single package of proposed rule changes in Q1 2019.

Recommendation 5

We recommend that the Financial Conduct Authority should issue guidance for contract-based pension providers on financial and non-financial factors, to follow the guidance given by The Pensions Regulator in its Guide on investment governance.

The Law Commission proposed additional guidance on financially material and non-financial factors for firms operating workplace personal pension schemes. In summary, when making investment decisions for such schemes:

- Firms should take account of financially material risks, including where these relate to ESG;
- Firms may take account of non-financial factors, provided this does not risk significant financial detriment to scheme members and the firm has good reason to think that scheme members collectively share the concern.

The FCA notes that additional guidance would be helpful for firms and commits to consulting on this as part of the package of proposed rule changes in Q1 2019.

18th June 2018

If you have any questions or comments on this briefing note please contact me at fergus.moffatt@uksif.org.