

UKSIF Response to FCA CP19/15: Independent Governance Committees: extension of remit

Introduction

The UK Sustainable Investment and Finance Association (UKSIF) is the membership organisation for those in the finance industry committed to growing sustainable and responsible finance in the UK. Our vision is a fair, inclusive and sustainable financial system that works for the benefit of society and the environment. UKSIF was created in 1991 and has over 240 members and affiliates including financial advisers, institutional and retail fund managers, pension funds, banks, research providers, consultants and NGOs.

We welcome this consultation and proposals from the FCA. We believe these proposals will improve how workplace and personal pension schemes manage environmental, social and governance (ESG) risks, and protect savers. As the consultation paper notes, ESG risks, including climate change, are particularly important for long-term savings and investments. It is therefore appropriate that regulation encourages asset owners to draw up policies to manage these risks.

As the consultation paper notes, these proposals fulfil a commitment the FCA made following recommendations from the Law Commission's review of the fiduciary duty of investment intermediaries. The DWP implemented these recommendations for trust-based schemes through October 2018 amendments to the Investment Regulations¹ (the October 2018 regulations) requiring trustees of trust-based pension schemes to set out their approach to financially material ESG factors in their statement of investment principles. It is important that savers, whether their scheme is trust- or contract-based, are afforded an equal degree of protection against financially material ESG risks. However, the consultation paper's proposals risks creating a disparity in the way trust- and contract-based pension schemes manage ESG risks such as climate change. Our response to this consultation suggests ways to address this disparity.

Q1: Do you agree that IGCs should report on the adequacy and quality of their firm's policies on ESG issues, member concerns and stewardship?

Q2: Do you agree that IGCs should report on how the firm has implemented its policies on ESG issues, member concerns and stewardship?

We agree with both of these proposals. The purpose of IGCs is to secure best value for beneficiaries. It is therefore appropriate that they are given a mandate to evaluate firms' policies on financially material ESG factors, as well as how well those policies have been implemented. However, the draft Handbook text could be improved in two areas. First, the definition of 'financial considerations' is too restrictive, and risks hindering IGCs' ability to scrutinise firms policies on ESG issues. Second, the draft Handbook text makes no references to the importance of considering ESG risks in the context of the time horizons over which beneficiaries are likely to save and draw down. Lastly, we believe the FCA should consider requiring the IGC to consult people with relevant experience and expertise when considering the adequacy of a firm's ESG policies.

Definition of financial considerations: scope

¹ The Occupational Pension Schemes (Investment) Regulations 2005.

The proposed new duty for IGCs is established in draft section COBS 19.5.5 R (2B), which would give IGCs a duty to consider and report on a firm's policy in relation to financial considerations.

Elsewhere, the draft handbook text would define 'financial considerations' as 'factors which a firm considers are material to the financial performance of an investment, including environmental, social and governance factors (including climate change)'.

While we welcome the creation of this new duty, its scope is limited. The draft Handbook text would only require IGCs to consider only how well a firm approaches factors which the firm has deemed financially material. We believe IGCs should have a duty to assess the firm's policies in relation to any factor which the IGC considers is financially material, including those which the firm may have omitted to consider. Giving IGCs this broader duty would give them the job of scrutinising whether a firm has missed any ESG issues. For firms that have not previously considered ESG factors, giving the IGC this wider duty would better support the integration of ESG factors, and thereby better protect savers from financially material ESG risks.

Giving IGCs a broader duty as suggested above would align these proposals with the October 2018 regulations. The October 2018 regulations require trustees to make a judgement about whether ESG factors are, or may become, financially material. IGCs should be given a comparable duty since, as the consultation paper notes, "IGCs have a similar role to the trustees of occupational pension schemes".²

We believe this could be addressed by a minor amendment to the proposed definition in Annex A, along the following lines. Our suggested addition is in bold type.

'financial considerations' means 'factors which a *firm or an IGC* considers are material to the financial performance of an investment, including environmental, social and governance factors (including climate change)'.

Time horizons

In the introductory text, the consultation paper refers to pension schemes as long-term investors as part of the reason they should consider ESG risks. However, aside from the proposed guidance, which references the 'long-term sustainability' of an investment, the proposed Handbook text makes no mention of time horizons in setting out how IGCs should assess the adequacy of a firm's policy on financially material ESG factors. Different ESG risks may crystallise over different time horizons. Even if risks are judged unlikely to crystallise in the near future, firms may still need to act now.

This view was echoed by Prudential Regulation Authority (PRA) guidance to banks and insurers which advised them to assess whether their holdings are vulnerable to climate-related financial risk, even where that risk has not yet crystallised.³ The PRA warned firms that they should not assume the existence of a liquid market for assets exposed to transition risk. For pension schemes, the potential of an illiquid market creates value for money risks for beneficiaries of schemes that hold those kinds of assets. The Pensions Minister echoed this view recently, saying that for pension

² Paragraph 2.4.

³ Bank of England Prudential Regulation Authority, 'Enhancing banks' and insurers' approaches to managing the financial risks from climate change', SS3/19, April 2019. For example, 3.10-3.12.

schemes to act prudently with respect to assets exposed to transition risk means timing the market perfectly and realign portfolios shortly before valuations fall.⁴ The speed at which these risks may crystallise is uncertain, but the PRA has warned that it could happen quickly, in the form of a Minsky moment.⁵

We therefore believe it would be appropriate to introduce a new term ‘appropriate time horizon’ in the list of defined terms in Annex A along the following lines:

‘Appropriate time horizon’ means ‘the length of time that a *firm*, or an *IGC*, considers is likely to pass before beneficiaries begin to draw down their savings’.

Introducing this definition would allow further amendments to the draft Handbook text and align these proposed rules more closely to the October 2018 regulations.⁶ This will afford savers equal protection from ESG risks whether their pension scheme is trust- or contract-based.

Firstly, we believe the draft Handbook text should be amended to be clearer about the scrutiny and reporting duty which the FCA proposes to place on IGCs. The draft text does not mention the time horizon over which the IGC should assess the adequacy of the firm’s policy. The long time horizons are a crucial factor which any assessment of a firm’s policy must take into account. This is reflected in the October 2018 rules, but not in the FCA’s proposals. We therefore think the following section of the draft Handbook text could be amended as follows, building on the definition we proposed in answer to Q1. Our suggested additions are in bold type.

COBS 19.5.5R

(2B) the *IGC* will consider and report on:

- (a) the adequacy and quality of the *firm’s* policy in relation to *financial considerations*, including how those considerations are taken into account **over the appropriate time horizon** in the *firm’s investment* strategies and *investment* decision making; and...

IGCs & advice

Assessing the quality and adequacy of a firm’s ESG policies is a new duty for IGCs, and one which may require a new and specialist set of skills. IGCs should be encouraged, or required if possible, to seek advice from suitably qualified people on the kinds of ESG risks that schemes may face. The FCA could also explore setting up a process of sharing knowledge and best practice for IGCs and for schemes.

⁴ ‘Investing in action to combat climate change’, Guy Opperman MP, 1st July. Speech during London Climate Action Week 2019. Accessed 12/07/19. <https://www.gov.uk/government/speeches/investing-in-action-to-combat-climate-change>

⁵ ‘Avoiding the storm: Climate change and the financial system’, Sarah Breedon, PRA, 15th April 2019. Speech to Official Monetary and Financial Inclusions Forum, London. Accessed 12/07/19. <https://www.bankofengland.co.uk/-/media/boe/files/speech/2019/avoiding-the-storm-climate-change-and-the-financial-system-speech-by-sarah-breedon.pdf>

⁶ The Occupational Pension Schemes (Investment) Regulations 2005, regulation 2(4).

Q3: Do you agree that IGCs should report on the firm’s policies on these issues for both pathway solutions and workplace personal pensions?

Yes. ESG factors can be material even in the short term, so it is sensible for IGCs to report on the adequacy and quality of firms’ policies for pathway solutions as well as workplace personal pensions.

Q4: Do you agree that firms should make the IGC’s annual report publicly and prominently available, with 2 prior year reports for comparison?

Yes.

Q5: Do you agree that the proposed guidance should apply more widely, to all firms that provide pension products and all life insurers that provide investment-based life insurance products?

Yes, although we believe the proposed guidance risks conflating non-financial with financial ESG factors, and should be clearer about the need to consider the risks over the time horizons of the investments.

Lack of clarity about financial vs non-financial ESG factors

We are concerned that the proposed guidance for firms is unclear, and fails to distinguish non-financial ESG factors with ESG factors which are financially material.

The reference in draft sections SYSC 3.2.23G (2)(a) and SYSC 4.1.15G (2)(a) to ‘risks to the long-term sustainability of an investment, such as environmental, social or governance risks (including climate change)’ is unclear. The ‘sustainability of an investment’ may be understood to mean financially sustainable, or it may be interpreted as referring to non-financial sustainability factors. The guidance should make clear the FCA’s expectation that all schemes should consider financially material ESG risks, and that firms should consider non-financial ESG risks which may crystallise in the future and become financially material.

These sections of the proposed text risk creating confusion by recreating provision in the definition of ‘financial considerations’. We interpret these sections as aiming to encourage firms to consider future risks arising from ESG factors which have not yet crystallised, as well as ‘financial considerations’ (which only includes ESG factors that are financially material now, as per the proposed definition of this term.)

To make the sections clearer, we would suggest replacing SYSC 3.2.23G (2)(a) and SYSC 4.1.15G (2)(a) with the following text:

risks arising from any environmental, social or governance event or condition which, if it occurs, could cause an actual or a potential material negative impact on the value of the investment arising from an adverse sustainability impact.

We believe this is a better definition, but it also aligns with a forthcoming EU regulation, which may apply to UK IORPs including workplace personal pension schemes.⁷ By adopting this definition now, the FCA may avoid having to revise this guidance in the future.

⁷ Proposal for a Regulation of the European Parliament and of the Council on sustainability-related disclosures in the financial services sector. COM (2018) 354 final. 2018/0179(COD). Art. 2(t).

Appropriate time horizons

While the proposed Handbook text in SYSC 3.2.23G (2)(a) and SYSC 4.1.15G (2)(a) makes welcome reference the 'long-term', we believe that all factors listed in sub-sections under SYSC 3.2.23G (2) and SYSC 4.1.15G (2) should be considered over a timescale which matches the timescale over which beneficiaries are likely to save, then draw down their pensions. We therefore propose the following amendment to those sub-sections. Our proposed language would also fully align the draft rules with the October 2018 regulations. Our suggested additions are in bold type.

SYSC 3.2.23G & SYSC 4.1.15G

(2) As part of its *investment* strategy and decision making, a [*personal pension scheme operator/firm*] should take into account *financial considerations* **over the appropriate time horizon of the investments, including how those considerations are taken into account in the selection, retention and realisation of investments**, including...

Q6: Do you agree that we should focus our requirement for an IGC on firms offering pathway solutions to consumers?

UKSIF does not have a view on this question.

Q7: Do you agree with our proposed approach for providers with smaller numbers of non-advised consumers entering drawdown?

UKSIF does not have a view on this question.

Q8: Do you agree that IGCs must be in place in time to assess the initial designs of pathway solutions?

UKSIF does not have a view on this question.

Q9: Do you agree that we should be more prescriptive in our rules and guidance for firms and/or IGCs on how value for money should be assessed?

UKSIF does not have a view on this question.

Q10: We welcome your view on what legacy pension products should be compared with, when assessing value for money.

UKSIF does not have a view on this question.

Q11: Do you agree with the conclusion and analysis set out in our cost benefit analysis?

UKSIF does not have a view on this question.