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Changes to the Investment Regulations

IFoA response to the Department for Work and Pensions

27 April 2015

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27 April 2015

Dear Mr Koufou,

IFoA consultation response –Changes to the Investment Regulations

The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to respond to the Department for Work and Pensions' consultation paper on changes to the law on investments in occupational pension schemes. This response has been compiled by members of the Finance and Investment Board, the Resource and Environment Board and the Pensions Board of the IFoA.

We support the Law Commission's recommendations which enable pension scheme trustees to include a more holistic consideration of long-term financial and non-financial factors in their investment process. We also support the growth of new markets for investments providing both financial and social returns. As a result, we welcome the broad policy intent of the consultation document.

As the consultation document notes, this is an evolving area of investment practice and one with little commonality of language, the terms "ESG" and "ethical" being just two examples not clearly defined by law. In practice it may be hard to define such words so that they are "future-proofed" without constraining the emergence of desirable practices. Instead guidance from tPR could help trustees interpret the wording of the regulations in line with the policy intentions.

We have proposed amendments to the wording of the Investment Regulations below, but caution against overly prescriptive wording of the regulations. In our view the right balance to strike is one which requires trustees to consider stewardship and the impact of ESG factors. This would mean that trustees are required to report on their policies in these areas, but permits a range of approaches, shaped by tPR guidance in this area.

We note the consultation document does not discuss whether any changes might be needed to regulation 2(2)(a) which defines who may give advice on Statements of Investment Principles (SIPs) . We suggest that it may be desirable to amend this regulation to reflect the wider list of considerations proposed for regulation 2(3)(b), for example by replacing "financial matters" with "relevant financial and other matters". We also note that it may also be appropriate to review section 36 of the 1995 Act (paragraph (2) in particular), as referenced in regulation 2(3)(a), in light of new or wider requirements. For the avoidance of doubt, we do not envisage that trustees would seek separate advice on financial and non-financial matters; instead we envisage integrated advice which supports the holistic consideration of long-term financial and non-financial factors in the investment process.

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Responses to consultation questions:

Question 1 How could regulation 2(3)(b) of the Investment Regulations be amended so that it more clearly reflects the distinction between financial and non-financial factors?

In practice SIPs commonly include statements of the trustees' investment beliefs and how they impact their investment principles, though this is not a formal requirement under regulation or tPR guidance. Evaluation of long-term risk, ESG and other factors require trustees to hold beliefs about the relevance and implications of these factors for the funding of the scheme. We would support an amendment to the Investment Regulations such that the SIP must summarise the trustees' investment beliefs, both generally and in reference to these factors. This could be introduced as a new sub-paragraph under regulation 2(3), between current sub-paragraphs (a) and (b):

their investment beliefs, including those relating to social, environmental and ethical factors and the extent to which such factors may be financially material to the scheme;

and amending regulation 2(3)(b)(vi) as follows:

~~the extent (if at all) to which social, environmental or ethical considerations~~ ***how their investment beliefs*** *are taken into account in the selection, retention and realisation of investments.*

We have retained the words "social, environmental and ethical" in this proposed wording to support a more holistic consideration of long-term financial and non-financial factors in their investment process.

We agree that trustees should be required to state their policies with regards to evaluating long-term risks, as suggested in Chapter Two paragraph 10 of the consultation document. We suggest that this is achieved by the following amendment to sub-paragraph (2)(3)(b):

(iii) risks, including the ways in which risks are to be measured and managed ***over the long-term;***

Chapter Two paragraph 10 also seeks views on whether trustees should be required to state their policies with regards to determining whether and in what circumstances it would be appropriate to make investment decisions on the basis of non-financial factors. We do not consider the term "non-financial factors" to be well-defined or well understood, notwithstanding our use of it in this response.

Many, if not all, factors may ultimately have a financial dimension. The Law Commission has said that "there is no impediment to trustees taking account of environmental, social or governance factors where they are, or may be, financially material. … The law goes further: trustees should take account of financially material risks."[1] It has also said that "In general, non-financial factors may be taken into account if 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."[2] We would argue that, if a "non-financial" factor fails this second test, then it is financially material to the decision and so should be taken into account by virtue of the first piece of guidance.

We therefore suggest that the relevant distinction is between those factors which are, or may be, financially material, and those which are not.

The question of whether or not a factor is, or may be, financially material to an investment decision is not clear-cut. Our proposed new sub-paragraph under regulation 2(3) encompasses consideration of this question. Rather than providing further detail in regulations, we consider this area is best

[1] Paragraph 1.19-1.20 of "Pension trustees' duties when setting an investment strategy: Guidance from the Law Commission"

[2] Paragraph 1.25, *ibid.*

addressed through supplementary guidance. We therefore recommend that tPR is asked to increase its guidance and education for trustees on this topic, including providing guidance on complying with the relevant sections of the Investment Regulations.

Question 2 Do you agree that amending the Investment Regulations to require trustees to comply with the current requirements in the Stewardship Code or explain why they have not done so, is the most appropriate way to implement the Law Commission's recommendation?

If not, what approach would be more appropriate to encourage trustees to consider their approach to stewardship?

One of the intentions of our proposed amendments is that Trustees who do not believe that long-term, ESG or ethical factors are relevant to their investment policies should state the beliefs that lead them to this conclusion within their SIP. This would encourage greater focus from trustees in this area on an at least triennial basis.

We believe it would also be beneficial to explicitly address stewardship in the Investment Regulations. This could be achieved through an additional item for regulation 2(3)(b):

stewardship, including whether and how they engage with companies, and whether and how they exercise rights (including voting rights) attaching to their investments;

and deletion of regulation (2)(3)(c).

As noted in our introduction, the regulatory environment should enable trustees to hold a range of investment beliefs and adopt a range of investment approaches. Our preference is therefore to omit references to the Stewardship Code in the regulations themselves and leave this to tPR guidance, which can be amended more readily to reflect emerging best practice. We believe the amendments we have proposed allow for a diversity of approaches and recognise that this is still an emerging field.

Question 3 What steps would trustees need to take to comply with any amendments to the Investment Regulations, as set out in Chapter 2?

What, if any, costs would be involved in meeting any new requirements?

The steps that trustees would need to take will depend on whether or not they have previously articulated their beliefs and formulated policies on matters such as stewardship, long-term risks and incorporation of non-financial factors into investment decisions. We expect that many schemes – particularly smaller ones – will need to carry out additional work in this area, with the help of their advisers. The Law Commission has clarified that trustees should take into account factors which are financially material to investment performance, which may include those relating to ESG issues and long-term considerations. In view of this, we consider that most additional work relating to formulating trustees' beliefs and policies in this area would stem from existing legal requirements rather than the proposed amendments to the Investment Regulations. Hence it is the costs associated with documenting these matters in the SIP that are most relevant to this consultation. We expect that such documentation will often be a relatively straightforward task, with limited cost implications, as it is simply an extension of the processes required by existing legislation.

To articulate the implications of investment beliefs for the selection of investments, trustees would need to follow a process to form their beliefs and discuss them in relation to their funding and investment strategies. Many schemes follow similar processes already to discuss their views of different return sources, management styles and their sensitivity to future economic scenarios.

The complexity of this process depends on the degree of consistency between different trustees' beliefs and the number of beliefs discussed. For schemes without a beliefs process in place, this would be an extra requirement, but for larger schemes exploring additional areas of beliefs this will likely be a small addition to an existing meeting cycle.

We suggest that any changes are introduced in a “light touch” manner so they are not seen as yet another burden for pension schemes, particularly the smaller ones. This includes allowing trustees to implement the additional requirements as part of the normal SIP review cycle. As many schemes operate a three-year cycle, and some schemes will be mid-review when the revised Regulations are published, an implementation period of (say) four years may be desirable.

Should you wish to discuss any of the points raised in further detail please contact Morgan Slebos, Policy Manager (Morgan.Slebos@actuaries.org.uk / 020 7632 1473) in the first instance.

Yours sincerely,

Nick Salter

Nick Salter
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