Principles for Responsible Investment

THE PENSIONS REGULATOR

21ST CENTURY TRUSTEESHIP AND GOVERNANCE

ABOUT THE PRI

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has 1500 signatories globally with $62 trillion in assets under management, 228 of whom are in the UK.

Responsible investment is an approach to investment that explicitly acknowledges the relevance to the investor of environmental, social and governance (ESG) factors, and the long-term health and stability of the market as a whole. It recognises that generating long-term sustainable returns is dependent on stable, well-functioning and well governed social, environmental and economic systems.

A STRUCTURED APPROACH TO IMPROVING ESG GOVERNANCE

In January 2016, the Principles for Responsible Investment (PRI), the United Nations Environment Programme Finance Initiative (UNEP FI) and The Generation Foundation launched a three-year project to clarify investor obligations and duties in relation to the integration of environmental, social and governance (ESG) issues in investment practice. This follows the publication in September 2015 of Fiduciary Duty in the 21st Century, which found that failing to take account of material ESG issues is a failure of a fund's fiduciary duty.

Throughout 2016, PRI has engaged with actors from across the UK capital market to understand key barriers to full integration of ESG issues into investment decision making. This review finds that strong governance helps to ensure that a fund fulfils its fiduciary duties to ultimate beneficiaries, which requires consideration of ESG factors in investment decision making and stewardship activities, directly and via third party providers.

SUMMARY OF OUR COMMENTS

We welcome the opportunity to contribute to this discussion. Below, we propose ways in which Trusteeship and Governance could be improved to encourage stronger consideration of ESG issues, in the long term best interests all market participants. While important steps have been taken in the UK market, research released in Summer 2016 demonstrated that more than half of

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Trustees still do not recognise the substantial financial risks[1] to their funds posed by climate change[2].

We group our comments around the following key areas:

- **ESG knowledge and competence**: to ensure that funds can fulfil their fiduciary duties, Trustees must have the knowledge and competence to ensure that ESG factors are fully incorporated into investment strategies. ESG factors should be referenced in training materials for new Trustees. Boards should regularly evaluate training needs and, if necessary, provide additional training to existing Trustees.

- **The role of The Pensions Regulato**r: We recommend that TPR engage critically with scheme practices on ESG.

- **Relationships with third parties**: We welcome TPR's intent to develop tools to support Trustees in scrutinising the advice and performance of investment consultants and recommend that these tools reflect the importance of ESG factors and stewardship to asset allocation and investment strategy.

  The selection, appointment and monitoring of fund managers is also of critical importance, whether carried out by Trustees or by investment consultants. We recommend that TPR develop tools to support selection, contracting and monitoring of fund managers.

  Since 2013, all investment manager and asset owner Signatories to the PRI have been required to report publicly on their responsible investment strategies. From 2017, PRI will also introduce reporting for investment consultants. These reporting frameworks are designed to support the evaluation of investment consultant and fund manager performance, and have been developed with substantial industry consultation. We recommend that they are an input to TPR's guidance on engaging with third parties.

- **Scheme size**: While we recognise that some small schemes have adopted very advanced practices, we also see evidence that scheme size is correlated with good governance and better ESG practices. We recommend that smaller schemes are required to reflect on size and whether it prevents good governance outcomes. The conclusions should be reported to TPR, which should continue to monitor this issue. This could be supported by simplification of scheme consolidation procedures by Government.

- **Additional tools**: We recommend that TPR consider the relevance of ESG factors to governance, investment risk and investment strategy development and incorporate recommendations into the upcoming tools and guidance in these areas. PRI's recent discussion paper, Crafting an Investment Strategy – A Process Guide for Asset Owners should be an input to this work.

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[1] For example, "Too late, too sudden: Transition to a low-carbon economy and systemic risk" from the European Systemic Risk Board, which estimated costs to the financial services industry of up to €400bn even in an 'orderly transition' scenario. https://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_6_1602.pdf

[2] http://www.professionalpensions.com/professional-pensions/news/2468851/climate-change-is-overblown-nonsense-and-not-a-material-risk-says-industry

- **Stewardship**: Incorporation of ESG issues into investment decision-making and stewardship of assets are required by a fund's fiduciary duty. Stewardship is increasingly important as the UK market moves towards passively managed funds. We recommend that records of voting and engagement activities are kept, and that Trustees promote meaningful, targeted disclosure to beneficiaries.

CONTACT

The PRI has experience in international ESG regulation and has developed a wealth of practical guidance on incorporating ESG factors into investment decision making. We would welcome further dialogue on the issues raised in this paper.

For further information, please contact:

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QUESTIONS

PRI is responding to questions 3, 5, 7, 8, 10, 11 & 13.

3. Should the requirement to appoint a chair and report on compliance with governance standards be introduced for DB schemes?

We agree that this would improve governance standards. We recommend reviewing the UK Corporate Governance Code and international pension fund codes, such as the retirement fund sector supplement of South Africa's King Code[3], or the Code of the Dutch Pension Funds[4], with a view to identifying whether elements of these codes can be applied to DB schemes in the UK.

5. Do you have any views as to how we can help new trustees bring their knowledge and skills up to the required standard within the statutory period? For instance would it be useful to make completion of the Trustee toolkit or other equivalent learning tool within six months mandatory? Or would the introduction of a six-month probationary period for new trustees help to meet standards of TKU? What are the difficulties associated with these options and how could these be solved?

To fulfil their fiduciary duty, pension funds must consider long-term value drivers, such as ESG factors. While some Trustees demonstrate good knowledge on these topics, the majority are not adequately engaging with the investment consequences of issues such as climate change[5].

This could be partially addressed by introducing training on the relevance and materiality of ESG factors into training materials for new Trustees.

However, the evidence suggests that current Trustees are not adequately aware of the investment implications of ESG factors. The materiality of ESG factors is dynamic and fast-moving. Current Boards should undertake regular skills assessments and seek additional training to address gaps in collective knowledge.

7. Do you have a view as to whether a CPD framework would assist trustees to meet the challenges of scheme governance? What are the difficulties associated with this option and how could they be solved?

As noted in our response to Q5, we consider ongoing skills assessment and training to be crucial.

8. What further education tools and products would you find useful to receive from us?

We recommend that TPR provide guidance on Trustee interaction with investment consultants. We elaborate on this further in our response to question 10.

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[3] http://www.iodsa.co.za/page/AboutKingIV

[4] http://www.pensioenfederatie.nl/Document/Publicaties/Servicedocumenten/Code_of_the_Dutch_Pension_Funds.pdf

[5] http://www.professionalpensions.com/professional-pensions/news/2468851/climate-change-is-overblown-nonsense-and-not-a-material-risk-says-industry

10. What do you think are the key challenges faced by trustees in engaging effectively with administration and investment governance and third party providers and advisers? What could we do to help them in addition to what we outline above?

Individual acts of Trustees are personal and conscious, but must be taken on receipt of “proper advice”[6]. In practice, many Trustees lack the confidence to scrutinize or challenge advice, and hence become overly reliant on such advice[7]. As a consequence, consultants strongly influence strategic asset allocation decisions and investment strategies of UK pension schemes. The advice given by investment consultants is often seen as not supporting proactive approaches to responsible investment.

In this context, we strongly welcomed both the launch of the FCA’s Asset Management market study (which recognises concerns regarding the strength of assessment by trustees of investment consultant activity) the 21st Century Trusteeship and Governance initiative from TPR.

The investment consultant industry is client-facing. For asset owners to get better outcomes from investment consultants (and service providers more generally) they need to be intentional in contract framing and performance reviews. We therefore welcome TPR’s intent to develop tools to support Trustees in scrutinising the advice and performance of investment consultants.

PRI has conducted extensive research in this area. PRI’s recent guidance paper, How Asset Owners Can Drive Responsible Investment: Beliefs, Strategy and Mandates recommends that Trustees:

- Develop and implement a statement on ESG incorporation and Stewardship in the Statement of investment policy.
- Integrate ESG factors in the selection process for asset consultants, including assigning specific weights to ESG factors. Trustees should ask how ESG factors are integrated into the advice that they provide and build requirements into contracts.
- Establish ESG factors as a standing item at consultant meetings.

Building on this, from 2017 onwards, PRI will begin to require investment consultant Signatories to the six Principles to publicly disclose their responsible investment activities. This will support pension funds to monitor investment consultant performance on ESG issues.

A consultation draft of a new reporting framework for investment consultants on responsible investment will be released in September 2016. This framework (the “Advisory and Consulting” module) was developed through extensive consultation with the UK investment industry.

We therefore recommend that tools developed by TPR reflect the importance of ESG factors and stewardship to asset allocation and investment strategy, and consider PRI’s upcoming Advisory and Consulting reporting framework as an input to this work.

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[6] The Pensions Act (2014)

[7] These were also reflections of the Myners review and the Kay Review.

Fund manager selection, appointment and monitoring is also of crucial importance, whether carried out by Trustees or investment consultants. PRI's research recommends that:

- For **selection** processes, Trustees or consultants acting on their behalf should undertake the following:
  - issuing investment mandates with ESG integration and reporting requirements, including on stewardship activities and turnover, with fees and pay structures that support ESG performance;
  - reviewing the investment manager's investment beliefs on ESG;
  - assessing the ESG skills of all investment staff;
  - setting out ESG reporting expectations;
  - assigning specific weight to ESG factors in investment manager appointment.
- **Appointment**: ESG factors should be embedded in Investment Management Agreements or equivalent. PRI has prepared series of model clauses for inclusion in contracts (see Appendix).
- For **monitoring** processes, stakeholders consulted for the UK Fiduciary Duty roadmap raised concerns that fund manager behaviour often does not fit the mandate. TPR should make it clear that the monitoring of fund managers, whether carried out by Trustees or consultants acting on their behalf, should include the following:
  - reviewing the investment manager's voting processes;
  - including ESG issues as a standard agenda item at performance review meetings;
  - assessing how the investment manager incentivises brokers and independent research providers to publish ESG research;
  - assessing how the investment manager engages policy makers on ESG issues.

Since 2013, all investment manager signatories to the PRI have been required to disclose their activities and progress towards the Principles on an annual basis. Building on the above recommendations, PRI's Reporting Framework disclosures are a comprehensive tool for evaluating the performance of investment managers.

We therefore recommend that TPR issue guidance to support fund manager selection, which reiterates that responsible investment is a core part of selection, appointment and monitoring of fund managers, with reference to the PRI Reporting Framework.

11. What should be done with those schemes that are unwilling or unable to deliver good governance and member outcomes? In particular, should small schemes be encouraged or forced to exit the market or to consolidate into larger scale provision? Is regulatory intervention required to facilitate this or can it be achieved through existing market forces?

While we recognise the good practices adopted by some small schemes, there is evidence that scheme size is correlated to good governance and better ESG outcomes. While careful outsourcing can address many of these scale-related issues, size nonetheless conveys a number of advantages.

Given the fragmented nature of the UK pensions market, it seems unlikely that consolidation will occur at scale in the absence of regulatory encouragement. We therefore recommend:

- Trustees reflect on whether scale has a negative impact on scheme governance and performance, including the consideration of ESG factors and costs. We recommend this occurs every three years, with results being reported to TPR and to scheme members. TPR should monitor the results.
- The Government simplify procedures for pension scheme consolidation.

13. Do you have any other thoughts on the issues raised in this paper or on how standards of trusteeship and quality of governance?

As noted earlier, high quality Trusteeship and strong governance structures help to ensure that a fund fulfils its fiduciary duties to ultimate beneficiaries, which requires consideration of ESG factors in investment decision making and stewardship activities.

TPR's guide to Governance for DC funds, released in April 2016, contains discussion of the importance of long-term value drivers, such as ESG issues. In addition to this, **we recommend that TPR engage critically with scheme ESG practice.**

We have two further recommendations relating to *tools and guidance* and *stewardship*.

Tools & Guidance

We recommend that TPR consider the role of ESG factors in the following upcoming initiatives:

- *Tools for self-assessing quality of governance and administration*: **We recommend that TPR include analysis of the firm's skills, capacity and delegation to external managers on ESG and stewardship factors within this self-assessment tool.**
- *Guidance on setting an investment strategy* and *tools to help trustees understand and manage investment risk*: The financial materiality of ESG factors, and the extent to which such factors are of importance to beneficiaries, should be considered in investment strategy and management of investment risk. **We recommend that ESG and stewardship are built into guidance on investment strategy development and management of investment risk**. PRI's recent discussion paper Crafting an Investment Strategy – A Process Guidance for Asset Owners supports asset owners, including their Board of Trustees and Executives, in the development and formulation of their investment strategy. We would welcome dialogue with TPR on how this could be developed further.

Stewardship

As noted in our opening comments, fiduciary duty requires consideration of ESG factors in investment decision making and stewardship activities, directly and via third party providers. Over recent years, UK pension funds have increasingly adopted passive investment strategies, limiting the tools available to mitigate idiosyncratic risk. Stewardship is therefore a crucial tool at their disposal.

For this reason, **PRI recommends that TPR require Trustees to maintain records of voting an engagement activities and provide meaningful disclosure in respect of their engagement and stewardship (including selective rationale for votes cast).**

APPENDIX – MODEL CONTRACT CLAUSES

- ***Investment Policy Statement*****:** *In carrying out its duties under this agreement, the Investment Manager will manage the client's portfolio in line with the client's investment policy statement and responsible investment policies, copies of which are attached as Appendix 1 to this agreement. The manager will also ensure the portfolio is managed in line with the Principles for Responsible Investment, to which the client is a signatory.*
- ***ESG integration:*** *Consistent with its fiduciary duties and with the client's investment policy statement and responsible investment policy (copies of which are attached as Appendix 1 to this agreement), the Investment Manager will establish a structured process for integrating environmental, social and governance issues into its investment processes and decision-making. The Investment Manager will ensure that its staff apply due care and diligence to following this process The Investment Manager will report annually on the implementation of this process and on how the analysis of environmental, social and governance issues has influenced investment decisions and portfolio performance.*
- ***Aligning time horizons:*** *The Investment Manager will have a process for monitoring current or potential investments in relation to relevant long-term factors such as ESG concerns. The Investment Manager will ensure that its staff apply due care and diligence to applying this monitoring process, including considering the extent to which such long-term factors generate investment risks or opportunities. The Investment Manager will report annually on the implementation of this process. The Investment Manager will report annually on portfolio turnover, including the costs incurred from portfolio turnover. The Investment Manager will, as part of this reporting, provide an explanation of any divergence from expected risk-adjusted returns.*
- ***Stewardship:*** *The Investment Manager will be an active owner, implementing a programme of engagement and, where relevant, voting, aligned with the Client's responsible investment policy statement and policies (copies of which are attached as Appendix 1 to this agreement). The Investment Manager will agree engagement priorities with the client on an annual basis. Where appropriate, the Manager will provide the Client with the opportunity to join company meetings. The Investment Manager will participate in, and promote, stewardship codes in countries relevant to the investment portfolio. The Investment Manager will report annually on the financial outcomes and the environmental, social and governance outcomes that have resulted from these activities, The Investment Manager will also report on how stewardship activities have influenced its investment decisions.*
- ***Public policy engagement:*** *The Investment Manager will allocate resources to public policy engagement on responsible investment-related issues, in line with the Client's investment policy statement and responsible investment policies, copies of which are attached as Appendix 1 to this agreement. The Investment Manager will agree engagement priorities with the Client on an annual basis, and will report annually on progress against these priorities.*
- ***Reporting:*** *In addition to the specific reporting requirements above, the Investment Manager will report annually on:*
    - *The staff and other resources it has for the implementation of its responsible investment commitments and for the analysis of ESG issues;*
    - *How its compensation structures align with the objectives of the mandate;*

- *The internal and external ESG research it uses in its investment research and decision-making, including information on its chosen research providers and on research expenditures;*
- *How its responsible investment and ESG-related activities (investment research and decision-making, active ownership, policy engagement) have affected the underlying value and strategy of the portfolio. The Manager will allow access by the Client to its staff and systems to monitor ESG integration in investment decision-making.*