

Andrew Bailey
CEO
Financial Conduct Authority
12 Endeavour Square
London
E20 1JN

15 July 2019

REVIEW OF INDEPENDENT GOVERNANCE COMMITTEES' EFFECTIVENESS

Dear Mr. Bailey,

I am writing to share the Principles for Responsible Investment's (PRI) perspective on the current regulatory framework for Independent Governance Committees (IGCs) and suggestions to improve its effectiveness. This reflects the view of the PRI and not necessarily that of its signatories.

The PRI welcomes the FCA's proposal to extend the remit of Independent Governance Committees to include ESG issues, stewardship and member views. Integrating material ESG issues into investment strategy and exercising stewardship of assets are essential to preserving and enhancing asset value. Furthermore, given that savers in contract-based schemes bear the risks of their investments, it is right that pension providers endeavour to engage with these savers to ensure that their sustainability preferences are considered.

However, the PRI is concerned that implementation of the proposed changes would still allow for significant regulatory arbitrage between contract- and trust-based pension schemes. These differences could potentially undermine the effectiveness of the proposed reforms in practice. They could also expose beneficiaries of contract-based pensions – which includes large numbers of low-wage auto-enrolled workers – to long-term risks to their pension savings.

These concerns are set out in further detail below, as well as some proposals for how regulation around independent governance committees and contract-based pension schemes may improve outcomes for savers. As part of the FCA's review of the effectiveness of IGCs and the regulatory regime this business year, we believe addressing the following issues should be prioritised.

(i) *Accountability*

IGCs currently face little accountability to ensure they meet their duty to act in members' best interests. The FCA's regulatory remit should be expanded to include oversight of the activities.

IGCs were introduced in part to address an accountability deficit in the market for contract-based pension schemes – employers had little incentive to ensure that employees were receiving value for money. However, IGCs suffer from many of the same structural issues.

As the Office for Fair Trading's 2013 investigation demonstrated, employers often lack the capacity and incentives to ensure members receive value for money. Providers, as the party which IGCs have been created to oversee, are similarly lacking in incentives to ensure IGCs are fulfilling their duties to members. This leaves only scheme members, a large number of whom were auto-enrolled in their pensions and thus are less likely to be engaged.

Nor is the information currently disclosed conducive to accountability. A ShareAction report¹ found a lack of disclosure of key data, and an absence of benchmarking, meaning members would be unable to understand whether their provider is offering good value for money compared to peers.

(ii) Independence

As part of the regulatory oversight of IGCs proposed above, the FCA should seek to ensure that IGCs are independent in practice.

While the FCA has attempted to ensure that IGCs are independent – for example by requiring a majority of independent members on the scheme – the lack of accountability set out above is likely to weaken the effectiveness of these requirements. For example, while the FCA requires the recruitment process for committee members to be open and transparent, there is no independent or incentivised party who can reasonably be expected to ensure that this is the case.

IGCs are resourced and often also advised by the provider. This may cause IGCs' understanding of ESG and stewardship issues to reflect that of the provider rather than be independently formed. IGCs also lack the ability to change investment providers in the event that members are receiving poor value for money or the integration of material ESG issues in the default fund is inadequate. These issues further undermine the capacity of IGCs to be independent in practice.

(iii) Reporting

As set out in the PRI's consultation response providers, rather than IGCs, are the appropriate body to report to beneficiaries on their ESG integration, stewardship and approach to member views. The IGCs' role should be to provide commentary on the adequacy of these policies and their implementation.

¹ <https://shareaction.org/wp-content/uploads/2018/02/PolicyReport-IGCRanking.pdf>

IGCs' role is to ensure that providers are acting in beneficiaries' best interests. They are not actively involved in the design of default investment strategies or policies around ESG integration and stewardship. Shifting the onus for reporting to the provider will ensure that the body which participated in investment decisions is responsible for explaining them, and will free up the IGC's time to focus on their crucial oversight role.

(iv) *Skills*

The minimum terms of reference for IGCs should include the condition that at least one member has ESG expertise, while all members should undergo training on ESG risks and opportunities.

The current composition of IGCs reflects their existing remit of ensuring value for money for scheme beneficiaries. The proposed expansion into oversight of ESG and other material risks, providers' stewardship policies and integration of member views will require a different set of skills and experience, and thus most if not all committees may need to significantly alter the current composition of their committees in the event this expansion occurs.

* * *

The PRI shares the government's view that the retirement outcomes of pension savers should not be affected by their presence in a contract-based scheme as opposed to a trust-based scheme. The aforementioned proposals set out a vision for how any such divergence in outcomes can be minimised. The PRI welcomes the dialogue we have had thus far with the FCA and are keen that this continues over the course of its Review.

Yours sincerely,



Fiona Reynolds
CEO
Principles for Responsible Investment