DWP consultation on clarifying and strengthening trustees' investment duties

NEST response

Introduction

We are writing on behalf of the National Employment Savings Trust (NEST) to respond to the DWP's consultation on clarifying and strengthening trustees' investment duties.

We welcome the DWP's move to introduce regulations setting a mandate for trustees to consider a broader range of financially material investment factors and to report on these policies in the Statement of Investment Principles (SIP).

Question 1

We propose that the draft Regulations come into force approximately 1 year after laying, with the exception of the implementation report, which would come into force approximately 2 years after laying.

a) *Do you agree with our proposals?*

We agree that one year, after laying regulations, gives those trustees who have a well thought out framework for considering how to act as a responsible investor sufficient time to prepare or make necessary adjustments in the next iteration of the SIP. However, we would note that there is a wide disparity in occupational scheme performance in this space – even for larger pension schemes – as evidenced by the recent ShareAction report **The Engagement Deficit**. For those schemes and trustees for whom this is uncharted territory, or who are reliant on consultants, support from other occupational pension schemes, government and the Regulator to identify and share best practice would help standards rise across the sector.

Allowing two years for the development of the implementation report gives enough time for trustees to be able to report meaningfully on their activities. NEST produces an annual Responsible Investment report, setting out how we have delivered on our commitments to being a responsible and active asset owner on behalf of our members.

b) *Do you agree that the draft regulations meet the policy intent?*

Yes.

Question 2

We propose to require all trustees of all schemes which are obliged to produce a SIP to state their policy in relation to financially material considerations including, but not limited to, those resulting from ESG considerations, including climate change?

a) *Do you agree with the policy proposal?*

Yes, we agree with these proposals. It is now commonly known and supported by academic and practical evidence that many ESG issues have a financial impact on investment portfolios. The mostly long-term investment time horizons of pension scheme members make addressing ESG issues by trustees even more pertinent as ESG risks and opportunities tend to materialise over longer time frames.

We agree that trustees should clearly articulate in the SIP their policy on addressing financially material ESG risks and opportunities across their members' investments as part of their explanation of other investment risks in default fund allocations.

Separate to the above, trustees should also report how they take account of non-financial factors where:

a. Members explicitly consent to this, for example, by choosing an ethical fund
b. The trustees have reason to believe that taking non-financial matters into account is broadly consistent with the views of members and factoring in non-financial matters is consistent with regulation

b) *Do you agree that the draft Regulations meet the policy intent?*

Yes. We agree that the draft regulations will encourage trustees to realise that ESG factors are mainstream investment considerations that should be assessed alongside other investment risks and opportunities. We believe this will help remove the barriers to these issues being addressed.

We support the increased emphasis on climate change given its systemic risk profile and its ability to profoundly impact the risk-adjusted returns of scheme members' pension pots. Because of this, trustees need to take a strategic approach to addressing climate risks when developing and setting their investment strategies and not simply delegate the management of these risks and opportunities to asset managers.

We would suggest that supporting guidance on how trustees should consider climate change in their approach will be especially important, as the evidence shows that particularly in DC schemes this is an area that is not well understood.

However, we would query the inclusion of social impact only in 'non-financial matters'. This positions social impact investing as entirely beyond the scope of financial returns, which does not always need to be the case. Certain social impact investments can enable trustees to enhance financial returns (in the same way that certain investments can have a social impact as well as delivering returns, especially when considered in a diversified portfolio) while delivering wider positive outcomes. We do not believe trustees should be deterred from considering them as part of the overall investment picture.

Question 3

When trustees prepare or revise a SIP, we propose that they should be required to prepare a statement, setting out how they will take account of scheme members' views?

a) Do you agree with the policy proposal?

We agree with this policy proposal. We believe that members' views, attitudes and behaviours should be considered when trustees are developing an appropriate investment strategy on their behalf and this should be described explicitly.

With regards to members' views on non-financial matters, it may be helpful for trustees to seek to understand scheme members' views on these matters. However, we don't believe trustees should be required to consider them in the design of the investment strategy. This could be something that trustees of single-employer schemes may wish to do if they can establish a clear consensus among their membership or based on the aims and objectives of the organisation. However, for large multi-employer master-trusts, establishing such a consensus is highly unlikely and trustees should be wary of being swayed by minority views if those views could affect financial outcomes.

b) Do you agree that the draft Regulations meet the policy intent?

We agree that the draft Regulations meet the policy intent, but again believe that guidance from the government or the Regulator will be required to ensure the policy intention is well understood.

Question 4

Do you agree with our proposals not to require trustees to state a policy in relation to social impact investment? If not, what change in legislation would you propose, and how would you address this risk of trustee confusion on this point?

No. For NEST social impact investment and green finance falls within the realm of addressing ESG considerations. Trustees can enhance financial returns from specific environmental or social investment opportunities whilst delivering positive outcomes for the wider society and the environment. Other investments can also have a positive social impact, even if they are not specifically targeted at such outcomes. Hence trustees should not be deterred from considering it as part of their investment duties.

Social impact investment can be a financially material consideration. Omitting this approach from the draft Regulations will not only add to trustees' confusion about the financial materiality of impact investments, but could prevent trustees from exploring potentially profitable investment opportunities and achieving better diversification for members.

This also conflicts with the government's aims and ambitions to create a culture of social impact investing in the UK to help:

- increase the choice of savings, investment and pension products that offer social impact
- broaden sources of funding for enterprises targeting social impact as well as financial return.

Meeting these aims would be made easier if trustees were encouraged to work towards including a meaningful allocation to social impact investment in their default funds as the market develops, subject to the investments meeting appropriate risk and return criteria. This *should* form part of trustees' policy in the SIP on how they're considering financially material risks and opportunities including ESG factors.

There is now a solid foundation for social impact investment and strong momentum for the concept to be considered a mainstream approach in schemes' default funds. We believe the DWP would miss an important opportunity to help steer the market forward if it is not made part of the new legislation. Including it will create a favourable environment and supportive framework for social impact to flourish in the UK and will also help towards meeting the purpose of the UN Sustainable Development Goals.

Question 5

We propose that trustees should be required to include their policy in relation to stewardship of the investments (including monitoring, engagement and voting) in the SIP

a) Do you agree with the policy proposal?

Yes. We commend the DWP's expanded remit of stewardship (to include engagement, monitoring as well as voting) and its emphasis on the relevance of stewardship to trustees' fiduciary duties, regardless of size of pension scheme or whether investment management is outsourced to asset managers.

We agree that stewardship is an important concept and one that should resonate with trustees as guardians of their members' savings. We stated in our response to the Law Commission's review that stewardship is an important component of our long-term investment approach and is aligned to factors that should protect and improve the value of our members' portfolio. We therefore support the DWP's proposal to encourage trustees to consider and subsequently disclose in the SIP their stewardship policy and how it fits within their wider investment approach. We would note that this is closely aligned with the UK's Stewardship Code and the Principles of Responsible Investment.

b) Do the draft regulations meet the policy intent?

In part. The draft regulations meet the policy intent as far as these requirements should help focus trustees' minds on robust stewardship policies. It will also make it easier for them to properly assess and challenge the practices of their asset managers. These changes will hopefully raise standards of stewardship and accountability through the investment chain.

As set out in our answer to Question 6 below though, we would also like to see greater detail from trustees on how they intend to implement and report on the success of their policy – whether it is delivered in-house or through external fund managers.

In addition, it would be helpful to provide clarity as to what appears in the actual SIP and what could be referenced in a separate document that can provide much more detail, but could be updated regularly, without a full revision of the SIP. This is the approach NEST has taken – we set out our principles for voting and engagement within the SIP, and link to detailed policy and delivery documents.

Question 6

When trustees of relevant schemes produce their annual report, we propose that they should be required to:

- *prepare a statement setting out how they have implemented the policies in the SIP, and explaining and giving reasons for any change made to the SIP, and*

- *include this implementation statement and the latest statement outlining how trustees will take account of members' views in the annual report.*

a) Do you agree with the policy proposal?

Yes. We agree that the annual report is a good place for trustees to report on their responsible investment activities, alongside more general investment reporting. This type of reporting will oblige trustees to demonstrate to members and stakeholders how they are applying the policies they've set out in the SIP.

We would like to see - via regulation or guidance - the duties on trustees go further than just articulating a stewardship policy. Our concern would be that a policy document can appear to be making the right noises about the importance of stewardship, but without a clear explanation of how this policy will be implemented, monitored and revised, it risks tokenism. Stewardship activity (whether it is voting, engaging with companies, or looking to strengthen shareholder rights in various markets through engaging with regulators and standard setters), should have clear objectives and a transparent way of measuring success and impact and, finally, reporting outcomes to beneficiaries.

We agree with the proposal to include the latest statement outlining how trustees will take account of members' views, subject to the caveats outlined above in our answer to question 3.

b) Do the draft regulations meet the policy intent?

Broadly, subject to the comments above.

Question 7

We propose that trustees of relevant schemes should be required to publish the SIP, the implementation report and the statement setting out how they will take account of members' views online and inform members of this in the annual benefit statement.

a) Do you agree with the policy proposal?

Yes. We agree because providing information on how members' money is invested and the types of ESG issues addressed will help promote trust and boost confidence in pension savings.

Whilst we support the DWP's proposal to ask relevant schemes to make the SIP accessible on the website for scheme members and wider public, such a detailed document is not necessarily designed for members. If the DWP wants the SIP to be made available to end savers, it should consider proposing that the SIP is presented and communicated in a way the public would understand and engage with. Alternatively, a general requirement for trustees to consider how information on ESG and responsible investment found in the SIP is communicated to members would make sense.

We would also caution against assuming directing members to this information from the annual benefit statement will lead to engagement with the content. Evidence shows that annual benefit statements are rarely read. The list of information needing to be signposted from the annual benefit statement is also growing, given the changes to disclosure regulations earlier this year. The longer and more cluttered the annual benefit statement becomes, the less easy it will be for members to find and understand the information they really need. If the policy intent is for members to know their schemes invest according to a set of investment principles and to understand them, schemes should be encouraged to rethink the format of the SIP or accompanying document and be creative in how they inform and draw members' attention to it.

b) *Do the draft regulations meet the policy intent?*

Yes with regards to publishing on the website, but we have reservations about the utility of including this information in the annual benefit statement.

Question 8

Do you have any comments on the business burdens and benefits and wider non-monetised impacts we have estimated in the draft impact assessment?

In most cases the potential cost impact associated with complying with the proposed amendments should be reasonable. In general terms the likely costs would be one-off and associated with debating and settling on a policy. However, this may in turn result in needing to set aside additional time to review and monitor additional aspects of reporting from asset managers.

It is worth noting that for some schemes there may well be additional costs as their approaches and processes became more sophisticated. In turn these schemes may require the assistance of third party providers of voting, engagement and research services, in addition to in-house personnel.

The creation of a separate 'implementation report' may be time consuming and burdensome, but we agree that it's important for those schemes that are not reporting how they are delivering their policies to do so. This can be done through existing reporting methods which need to be clearly sign-posted or via the new implementation report.

For example, NEST produces a Responsible Investment annual report that updates members and stakeholders on its activities as a responsible investor including how it is incorporating material ESG factors in its investment approach and outcomes from its stewardship practices. Furthermore, NEST is reporting on how it is identifying and managing climate-related risks and opportunities in its investment strategy against the Taskforce for Climate-related disclosures (TCFD) framework in its annual reports and accounts. Several MPs are promoting this framework as the industry standard for climate-related reporting, so we believe climate reporting shouldn't be duplicated in the implementation report.

Question 9

Do you have any other comments on our policy proposals, or on the draft Regulations which seek to achieve them?

The importance of high quality guidance and best practice examples should be carefully considered alongside the new regulations.

Question 10

Do you agree that the revised Statutory Guidance clearly explains what is expected of trustees in meeting their duty to publish the SIP, implementation statement and statement of members' views?

Yes. The revised guidance provides a clearer picture for trustees. However, we feel the guidance on social impact investment as a financially material consideration (if trustees wish to consider it as that) should be included as well. Doing so will help clear up misconceptions that impact is solely an ethical choice or about investing to satisfy members' views.

Question 11

What evidence or views do you have of how well the other requirements in the SIP are working? What areas for further consideration and possible future change would you suggest?

One area that we believe would be worth considering, is including something within the SIP about trustees' duties to help members of DC convert their savings into income for retirement in light of freedom and choice.