HYMANS ROBERTSON

Responsible Investment:

A guide for Defined Contribution trustees

In 2018, the UK Government introduced new Investment Regulations for trust based defined benefit (DB) and defined contribution (DC) schemes.

What the regulations require

The 2018 Regulations require that, with effect from 1 October 2019, trustees must set out, in their Statement of Investment Principles, their policy on:

1. How they take account of 'financially material considerations' which include, but are not limited to ESG factors, including climate change;
2. Their approach to stewardship activities for the assets held; and
3. The extent to which any non-financial matters are taken into account.

In addressing these requirements, trustees need to consider and set out how their approach is appropriate for determining both the strategy, which includes the structure of the default arrangement, and its implementation.

Reference is made to an "appropriate time horizon", the intention being that trustees consider longer-term risks within their investment arrangements.

Clearly, the time horizon for a DC member will depend on how far they are from their selected retirement age, assuming they are invested in a default arrangement that is structured either as a lifestyle strategy or a target date fund.

Stewardship policies should cover voting, engagement and monitoring. This should include how trustees engage with companies and investment managers on matters such as "performance, strategy, risks, social and environmental impact, and corporate governance". It should also include the exercise of any rights that come with particular investments.

Disclosure requirements for DC trustees

Trustees of DC schemes have additional requirements to disclose their approach, being:

- **From 1 October 2019,** trustees must publish their Statement of Investment Principles on a publicly accessible website. This ties in with the requirement to publish Chair's Statements online.
- **From 1 October 2020,** trustees must also annually publish a report demonstrating how they have complied with their policies.

Glossary

ESG is used to collectively describe a series of different risk factors arising from **Environmental** (resource scarcity, waste management, pollution, energy efficiency), **Social** (health & safety, workforce diversity, working conditions, data protection) and **Governance** (board structure, business ethics, shareholder rights, executive compensation) issues.

Responsible investment refers to investment practices that integrate the consideration of environmental, social and governance (ESG) factors into investment management processes and ownership practices, recognising that these factors can have a material impact on financial performance.

Stewardship describes the activities of investors in exercising the rights and responsibilities that come with asset ownership. These practices can include voting on shares and engaging with company management but should also include the oversight by trustees of those to whom they delegate responsibility for such activities.

Trustees need to understand Responsible Investment across the investment process

The Regulations encourage trustees to take greater ownership and be aware of the consequences of their responsible investment policies, rather than adopting a "box ticking" approach. Where trustees' approaches have historically been somewhat manager centric, greater emphasis is now being placed on the consideration of financially material factors beyond implementation and there is a broader requirement for trustees to consider Responsible Investment issues at each stage of the investment process.

Trustees should pose themselves a number of questions about their current approach in developing their policy:

Objective setting

- To what extent are RI factors relevant given the members' timeframes?
- Has consideration been given to setting investment beliefs or specific RI objectives?
- Are there any views expressed by members that need to be considered?

Strategy development

- Do we need to update our default arrangement to take account of ESG factors?
- Can we demonstrate that any change to our default arrangement will leave members no worse off than at present?
- Does the self-select fund range still meet the needs of members?

Implementation

- How relevant is RI for the mandates in the strategy?
- Are manager RI policies explicitly considered in manager selection?
- How good are managers at integrating the consideration of ESG risks into their approach?
- Should RI be a differentiator in picking managers?
- Can we implement an RI strategy within the charge cap?

Monitoring

- Do the trustees receive any information (e.g. metrics, case studies) relating to the ESG characteristics of their mandates in reporting?
- Do the trustees review manager reporting on ESG issues and challenge manager activity?
- Do the trustees actively question managers on their stewardship activity?
- How frequently is this done?

Trustees can continue to delegate much of the implementation of their RI policy to their investment managers. However, the onus remains on trustees to both understand the approach taken by their managers and to effectively challenge those who they delegate this responsibility to.

The special case of climate change

Climate change is a systemic risk that has the potential to affect economies, financial returns and demographics and is singled out as an issue to be addressed by Regulations. The majority of members in UK schemes are still many years from retirement. The potential impact of climate change over the expected lifetime of a typical DC member could therefore be particularly significant. Policy action by governments over the shorter-term could also have an impact on investors.

There are several actions that trustees can undertake to better understand and begin to address the potential risks to DC pensions arising from climate change, which include:

- Undertaking regular training to understand both the current position and developments in climate risk, regulatory changes and market responses;
- Considering the extent to which climate risks arise in investment mandates, particularly passive mandates, and reviewing benchmarks where appropriate;
- Developing investment beliefs relating to climate risk and/ or acknowledging climate as a contributing risk factor to financial and demographic considerations and including this on the scheme's risk register;
- Discussing climate risk with investment managers and understanding how managers both reflect this in their decision-making processes and how they vote and engage with companies on climate risk and wider ESG issues;
- Determining how to report on climate risk exposures to pension scheme members.

It is inevitable that regulation and best practice regarding the consideration of climate risk will evolve. We therefore encourage trustees to ensure that they stay up do date with emerging legislation.

Consider what sort of Responsible Investor you want to be

Our "Core-Active-Leader" framework encourages trustees to consider "what sort of responsible investor they want to be". By recognising that there is a spectrum of positions that they could take, trustees can determine an approach to RI that is right for them and their scheme members, recognising this should be both proportionate and scheme specific.

The factors that inform trustees' approach to RI should include their investment beliefs, the complexity of the investment arrangements and their governance budget. Trustees should not however feel constrained in their approach and, where they believe it appropriate, they should strive to demonstrate higher standards of behaviour. We characterise the different types of responsible investor as follows:

Core

Trustees understand the relevance of RI factors to their investment arrangements but typically delegate responsibility for implementation to others. Trustees may pro-actively engage with managers on decision making.

Active

Trustees clearly understand and engage with RI matters in the development and implementation of strategy and actively seek approaches that are consistent with their beliefs. Trustees will challenge managers and service providers regarding the impact of RI factors on decision making and will evolve their strategy accordingly.

Leader

Trustees fully integrate all RI matters into the development and implementation of strategy. Their approach to RI is reflected in the broader culture and behaviours of the trustee body. Trustees place a greater focus on long term thinking and use collaborative powers to promote the adoption of best practices.

Within a DC context, where the use of pooled funds is common, trustees may perceive that they have little ability to have influence or create change and therefore gravitate towards a Core position. This need not be the case; regardless of asset size or the means of implementation, trustees should still consider how actively they want to engage with both their managers and the wider industry on ESG matters.

For more detail on our Core Active-Leader framework, please speak to your usual Hymans consultant.

Addressing the default strategy

Many trustees have historically consigned more ESG friendly strategies into self-select fund ranges, both in the belief that "responsible" and "ethical" were the same and that investing responsibly would impact on future returns. The revised Regulations mean that trustees need to review how RI considerations are reflected in the default arrangement.

DC default arrangements generally make use of pooled funds which may be accessed through a platform structure. Changing the default arrangement may not therefore be straightforward, but trustees still need to consider their RI beliefs and policy, and how these are implemented in practice within the default strategy.

In passive arrangements, one consideration is the choice of benchmark. The greater availability of ESG information is allowing investors to develop a broader range of indices that reflect varying combinations of ESG and other factors. Such approaches offer practical alternatives for many investors.

Trustees should also consider how stewardship will be approached in the default strategy and whether the stewardship policies, practices and reporting of the selected managers are appropriate. Trustees need to consider how they will monitor and challenge the actions of their managers, particularly where funds are accessed via a platform.

Finally, consideration should be given to the communication of the default strategy. Where changes are made, this can be used to facilitate greater engagement with members.

Case Study: A bespoke default

One client, looking to reflect both member concerns and the sponsors own beliefs into their investment arrangements has spent considerable time working with investment managers to develop their own custom strategy. Their approach, which combines factor-based equity investment with an ESG tilt is to be deployed as the growth part of their default investment strategy.

By recognising both the requirements of their membership and the tendency of members to rely on trustees to make investment decisions, our client worked through a number of barriers to ensure that their approach was right for them. They were able to provide input into the development of the solution by the manager and were therefore able to satisfy themselves that members would be "no worse off" as a consequence of the changes, thereby addressing one of the key concerns of many trustees.

How should members' views be considered?

A significant change within the 2018 Regulations was that the consideration of ethical issues, social impact and members views are captured under the heading of "non-financially material factors". There is no obligation for trustees to develop a policy on their approach to such factors, although they can do so if they so wish.

The Law Commission's 2014 report on the ability of trustees to take account of non-financially material factors was clear. Trustees can do so if their decision meets the dual criteria of:

- a belief that most members would share the views being expressed; and
- the decision is unlikely to have significant financial detriment.

Trustees of DC schemes may wish to gain a better understanding of what their members want in order to take account of this information in their decision making. Trustees can go about this in a variety of ways, for example, by surveying their members or using focus groups to collect views. Broader market surveys can also provide more general information on the needs and wants of DC scheme members, although trustees need to ensure that they interpret survey results in an appropriate manner.

In all circumstances, care needs to be exercised in gathering and interpreting member views to ensure that all opinions are properly reflected, not just those of a vocal minority.

A key consideration for trustees in taking account of member views is to understand the way in which members act. We know that relatively few members make active choices about their investment arrangements, with the vast majority of DC members invested in default strategies. Trustees cannot therefore assume that members who care about ESG issues would automatically self-select and this should be reflected in how trustees develop and implement their RI policies.

Trustees may also wish to explore the manner in which DC investments are communicated to members. Where RI is a topic of interest to the membership of the scheme, trustees could use this as a basis for engagement or future communication. Some trustees may wish to work with their managers and/or advisers to develop communication tools that convey not just information about financial return, but the broader impact of investment strategies.

What do trustees need to do next?

Trustees need to ensure that their Statement of Investment Principles is updated and published by 1 October 2019. This is just the start. Policies define the behaviours and practices that trustees intend to demonstrate going forward and we suggest that, as a minimum, trustees focus on the following activities:

- Ensure investment beliefs are defined and documented;
- Schedule responsible investment training into the ongoing trustee education programme;
- Review your default arrangement and ensure that it remains fit for purpose;
- Ensure that the self-select fund range offers sufficient alternatives to meet members' needs;
- Confirm that your managers properly integrate the consideration of material ESG factors into their investment processes and if not, understand why not. Your investment consultant could help with this, for example, by providing RI ratings;
- Ask investment managers to include suitable RI information in their updates and ensure that managers are challenged to explain their actions. You may wish to discuss with your investment consultant what information would be useful; and
- Plan how you will report on compliance with your policies. Setting out a longer-term journey plan to address RI may help you achieve this.

Please speak to your regular Hymans Robertson consultant to discuss further how we can help you.

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