

By email to: reinigorating.pensions@dwp.gsi.gov.uk

15th May 2014

To whom it may concern,

ShareAction (FairShare Educational Foundation) welcomes this opportunity to respond to the Department for Work and Pensions' consultation on quality standards in workplace defined-contribution pension schemes.

ShareAction is the UK's leading charity campaigning for Responsible Investment (RI). We monitor and engage with institutional investors and our goal is an investment system that serves savers, society and the environment. In particular, we work to encourage effective management of environmental, social and governance (ESG) risks, and active stewardship of listed companies through the informed exercise of shareholder rights. ShareAction also champions greater transparency and accountability to the millions of people whose long-term savings are entrusted to the capital markets.

ShareAction is a membership based organisation and we count amongst our members a growing number of globally recognised NGOs and trade unions, as well as over 8000 individual supporters. Our submission covers the points which fall within our area of expertise.

Introduction

We welcome the recognition in the Command paper that the same quality standards 'should apply to all workplace defined contribution (DC) schemes so that all savers benefit' (Section 0.2) and that the government, TPR and FCA will be 'actively working together to promote consistency and coherence in the regulatory regimes for both trust-based and contract-based provision' (Section 0.3). We have previously expressed concern that different regulatory standards and regimes can lead to regulatory arbitrage, putting members at risk from getting a poor deal. We also welcome the announcement in Sections 1.3 and 7.3 that minimum quality standards will be mandated through primary and secondary legislation, rather than relying on further guidance or voluntary codes of conduct from regulators.

We also welcome the governments' efforts to tackle the governance gap in contract-based pensions, through establishing Independent Governance Committees, as currently there are no agents in these schemes who are tasked with protecting members' interests. We have not given feedback on the ICG proposals here, as this consultation process asked for responses only on the changes to



shareaction.org

trusts and master trust standards. We would, however, be happy to share our thoughts on IGCs with officials.

Should master trusts have to meet the same independence standards as providers of contract-based schemes?

In our view, the application of these independence standards to master trusts would be a positive step towards addressing the potential conflicts of interests which may arise when boards are appointed by the provider. However, it is worth noting that master trusts have positive characteristics which are not reflected in the contract-based sector. The most significant of these is the fact that trustees are subject to fiduciary standards, whereas under proposals for IGCs the committee members will not be subject to fiduciary duties, nor will they have the powers required to exercise such duties.

In ShareAction's report *Whose Duty?*¹, we detail further how members of contract-based schemes are subject to lower standards of protection than members of trust-based schemes, in part because the FCA's 'Treating Customer's Fairly' rules impose no duties on providers to put members' interests first. Therefore, it would be better to raise standards and requirements for master trusts to mirror those of trust-based schemes, and not by looking to the contract-based model, as the former are more robustly governed.

We would welcome views on the proposed definition of 'independent' at Annex B

ShareAction welcomes the requirement for trustee boards and IGCs to include members who are fully independent of the provider. Independent, professional trustees often have valuable experience of investment, HR or communications which is beneficial to the trustee board and therefore the members. It is crucial, however, that these governing bodies can freely exercise their duty to act in members' interests and resolve all conflicts of interest for members' benefit. The Law Commission recently expressed concern that 'trustees who are appointed and paid by the provider may not be able to challenge the provider's actions'². In its DC workplace pension market study, the OFT highlighted the risk 'that some trustee boards may not be sufficiently independent of the master trust provider to avoid potential conflicts of interest'³. We are concerned that trustee boards composed entirely of independent, professional trustees appointed by the provider and representatives from the provider itself will not be able to provide effective scrutiny of that same provider.

Although we have no objections to the definition of independence as it would apply to an independent trustee, we are concerned about the prioritisation of independent trustees at the expense of stakeholders themselves having a role in governance of their pension schemes. In fact, we believe that scheme members' personal interest in the success of the scheme is a particular advantage. It has recently been argued by Demos that the 'idea of 'skin in the game' should be the guiding principle of economic and financial regulation'⁴. In other words, responsible capitalism

¹ ShareAction, 'Whose Duty? Ensuring effective stewardship in contract-based pensions', 2013, available at http://www.shareaction.org/sites/default/files/uploaded_files/policy/WhoseDuty.pdf

² Law Commission consultation paper: Fiduciary Duties of Investment Intermediaries lawcommission.justice.gov.uk/docs/cp215_fiduciary_duties.pdf

³ OFT 'Defined contribution workplace pension market study', 2014, available at http://www.of.gov.uk/shared_of/market-studies/oft1505

⁴ O'Leary, D., 'What's Mine is Yours', Demos Quarterly 2014 (2), available at <http://quarterly.demos.co.uk/article/issue-2/skin-in-the-game/>

can be best achieved if those responsible for the investment of other people's money also have some of their own money invested in the portfolio and share in the risk, not just the rewards. In the context of pension schemes it is the members and to a slightly lesser extent the employers who have skin in the game.

The interests and incentives of a member trustee will be well aligned with the interests of other members whose retirement security depends on the performance and quality of the pension scheme. Employer trustees also have skin in the game as they contribute their own money to the scheme and many employers are concerned to ensure that this cost buys a good quality benefit that they can be proud to offer their employees. The Kay Review argued for the importance of aligned incentives when agents are managing other people's money. A central aim of the Kay Review was to:

'Shift regulatory philosophy and practice toward support for market structures which create appropriate incentives rather, than seeking to counter inappropriate incentives through the elaboration of detailed rules of conduct'⁵

Unfortunately, recent developments in the master trust governance regime indicate that the later approach is still being pursued which, in the words of Professor Kay 'is likely to enjoy limited success'. We therefore propose that the requirement for occupational pension schemes to have at least a third of their trustee boards made up of member-nominated representatives is extended to all trust and contract-based providers, as members have the appropriate incentives, or 'skin in the game'. Employer representatives should also be allowed to sit on these boards. This is in keeping with the key principle set out in the Command paper that minimum standards of governance should apply to all workplace pension providers. The DWP may also consider making use of the government's reserve powers to increase this proportion to 50% for occupational schemes.

The TUC has also argued that member-nominated representatives are able to draw on better links to the scheme members and are able to "communicate clearly with colleagues about pensions, and take into account member interests and priorities when determining strategies for the pension scheme"⁶. We share the view that member representatives can provide a crucial link between the scheme and its savers. By allowing members the right to elect someone to act on their behalf, it helps to build trust in their scheme, and to build confidence that their money is being invested in their best interests. This is important because the success of automatic-enrolment is dependent on members' trust and confidence in pension saving. In addition to having a say in investment decisions, member representatives would also provide a valuable perspective on member communications.

In its initial call for evidence, the DWP expressed a view that member nominated representatives may not be considered appropriate for multi-employer schemes because of 'a lack of engagement from members and because of the problems of representation across a variety of employers and members'. However, NEST is obliged to maintain a Member Panel, which any member is able to apply to join. The panel is currently made up of representatives from a range of industries and backgrounds, illustrating that the selection of member representatives in large, disparate multi-employer pension schemes need not be overly arduous. Also, Unions provide another example that successful elections for member representatives can be held in organisations with diverse memberships.

⁵ Kay, J., 'The Kay Review of UK Equity Markets and Long-Term Decision Making', Final Report, 2012, p.9

⁶ TUC, 2008, 'The Member Voice in Pensions Governance: Progress to one-third member nominated trustees and beyond'

We agree with the duty set out in Section 1.57 and Annex B that ‘the provider must have arrangements in place to ensure that members’ views are directly represented.’ We believe that savers should have the right to a say in what happens to their money, by expressing their views when policies are developed, and by scrutinising the decisions made on their behalf. This culture of scrutiny and healthy debate should help to sustain and improve the quality of decision-making. Although mechanisms for directly representing members’ views, like AGMs are welcome developments these are by no means a substitute for member representation on governance bodies with actual powers. Section 1.57 on mechanisms for representing members’ views has not been given sufficient thought or attention in our opinion. For example, Legal and General’s AGM is cited as an example of good practice but they are yet to hold their first one, so how can DWP be sure that this will be an effective means of representing members’ views?

In ShareAction’s report, *Our Money, Our Business* we investigated Danish ‘Pensionskasser’, a type of fund owned and controlled by its members which is obliged to account to members through AGMs. Member delegates attend AGMs, vote and scrutinise the board but:

‘These delegates fulfil a somewhat different role to that of member nominated trustees: their role is not to make decisions, but to engage with decision makers on behalf of the membership at large.’⁷

The Danish pension system is consistently judged as one of, or the best, systems in the world by respected international rankings, such as by the OECD or the Melbourne Mercer Global Pensions Index.

We would welcome views on the proposed quality standards for trust-based governance which are summarised at Annex B.

As we noted in our previous submission, ShareAction favours the promotion through quality standards of Responsible Investment (RI). We define this as being investment which takes account of long-term environmental, social and governance (ESG) risks which may affect investment returns. This means addressing both investment governance at individual scheme level and the ability of the system as a whole to invest savers’ contributions to generate sustainable wealth. System level risks include, for example, excessive short-termism in investment horizons or inadequate investor attention to systemic financial risks. RI also requires investors to take an active role as stewards of investee companies, exercising voting rights and engaging in purposeful dialogue on ESG issues and other concerns.

Although the principles of RI are gaining acceptance in the investment industry, a significant barrier to adoption is confusion between asset owners, asset managers and advisors as to whose responsibility it is to initiate implementation of this approach. If the governance body of the asset owner, so the trustee board or the IGC in contract-based arrangements, was given a clear responsibility for designing the RI approach and monitoring its implementation amongst the asset managers, this would resolve the confusion. The Social Investment Research Council’s recent report looked into the barriers to adoption of social investment by institutional investors and also identified this confusion between asset owners, managers and advisors as a key barrier. Although social investment is not the same as RI, the analysis is applicable to both situations. This report also concluded that responsibility for initiating a socially responsible investment approach should be given to asset owners because:

⁷ ShareAction, ‘Our Money, Our Business’, 2013, available at <http://www.shareaction.org/research/reports>

*Financial intermediation involves asset owners delegating responsibility for investment decisions to asset managers, with investment consultants and others playing supporting roles in arriving at decisions. The asset owners' wishes are generally codified in investment mandates, which direct asset managers on how the portfolio should be invested.*⁸

Mandating governance boards to take seriously the long-term effects of investment decisions, and encourage asset managers to act as 'owners' rather than 'traders' or assets would benefit all schemes by contributing to a more stable investment system.

Are the requirements listed at paragraph 8 the right quality standards to be set in regulations for trust-based schemes?

The quality standards should address Responsible Investment by requiring funds to have a policy which addresses RI, ESG risks and stewardship. A recent ShareAction survey of the RI performance of UK occupational pension funds found that schemes with a specific Responsible Investment policy tended to be the most effective at taking ESG issues into account and engaging positively with investee companies.⁹

All schemes used under automatic enrolment should be required to comply with the UK Stewardship Code, disclosing whether and how they do comply in a comprehensive publicly available statement. Given that the Stewardship Code is a UK government initiative, introduced to address a major systemic failing exposed by the financial crisis and directed at long-term investors such as pension funds, there would seem to be no justification for pension schemes being used under auto-enrolment not to apply the Code's principles. At the very least, schemes should be required (as asset managers currently are under FCA rules) to disclose whether they comply with the Code and, if they choose not to comply, to explain why.

ShareAction also takes the view that schemes should communicate with members about Responsible Investment activities in a transparent manner, and engage with members about their interests and concerns on ESG issues. Schemes should be required to report on how the fund's Responsible Investment policy has been implemented, as well as the voting and engagement activity undertaken by the fund or on its behalf.

We would welcome the opportunity to meet with you to discuss the issues raised in this response. Should you have any queries, please do not hesitate to contact me.

Yours sincerely,



Catherine Howarth
Chief Executive, Share Action

⁸ Social Investment Research Council and London Economics, 'New Specialist Sources of Capital for the Social Investment Market', City of London Corporation, 2014, p.31

⁹ ShareAction, 'Entrusted with our Future', 2014, available at <http://www.shareaction.org/research/surveys>