POLICY BRIEFING | September 2016

New UK Pensions Regulator code of practice: a step forward for responsible investment

The UK Pensions Regulator has published a new code of practice that strengthens guidance on the consideration of environmental, social and governance risks in pension fund investments.

In July 2016, the UK Pensions Regulator published a new code of practice for defined contribution and hybrid pension schemes, together with supporting guides.[1] These have strengthened guidance for pension trustees on the consideration of environmental, social and governance (ESG) risks in fund investments. ShareAction is delighted to see this change. In practice, many schemes are still failing to take material ESG issues like climate risk into account in their investment decisions, believing that they have to focus solely on short-term returns.

Background

The UK Pensions Regulator has 14 codes of practice covering different types of pension scheme and aspects of the trustee role. While these codes are based on UK pension legislation, they are not legally binding and there is no direct penalty for failing to comply with them. Schemes can take an alternative approach to the codes, provided they meet the underlying legal requirements.

In July 2016, following a series of public consultations, the UK Pensions Regulator launched a new version of its code of practice no 13: *Governance and administration of occupational trust-based schemes providing money purchase benefits* (the code). The code applies to trustee boards of all occupational trust-based pension schemes that have two or more members and offer money purchase benefits (also known as defined contribution or hybrid schemes). The supporting guides contain recommendations and suggestions for best practice. ShareAction provided extensive feedback on the draft code and guides throughout the series of consultations and many of our suggestions were accepted in full. The Pensions Regulator has taken a significant step in highlighting long-term sustainability factors for the first time in its guidance, and we are pleased to have contributed to this work.

The Law Commission recommended in its 2014 report, *Fiduciary Duties of Investment Intermediaries*,[2] that the relevant pension investment regulations[3] should be reviewed to provide clarity for trustees on the extent to which they should consider ESG factors in investment. In practice, misconceptions about trustees' fiduciary duties, including their duty to act in beneficiaries' best interests, remain widespread in the industry. This means that many schemes are failing to take long-term sustainability factors into account,

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believing that they have to focus solely on short-term financial returns. The UK Government launched a consultation on how to implement the Law Commission's recommendations in 2015 but said there was insufficient consensus among consultation respondents to amend the regulations. We hope that in due course, this legislation will be amended to provide definitive clarity for trustees. Nevertheless, the revised code and guides are extremely welcome. They will impact more than 30,000 schemes with a total membership of nearly 6 million beneficiaries.[4]

Content of DC code

The code now states: "When setting investment strategies, we expect trustee boards to take account of risks affecting the long-term financial sustainability of the investments."

Content of supporting guides

Investment Governance guide

The Investment Governance guide refers to the UK Law Commission's 2014 review of fiduciary duty, and confirms:

- Trustees should take into account factors which are financially material to the performance of an investment.
- Where trustees think ESG factors are financially significant, they should take these into account.
- While the pursuit of a financial return should be trustees' main concern, the law is sufficiently flexible to allow them to take other, non-financial factors into account if they have good reason to think that scheme members share their view and there is no risk of significant financial detriment to the fund.

In this guide, the Pensions Regulator states that trustees should bear in mind that most investments in defined contribution pension schemes are long term and are therefore exposed to longer-term financial risks. These may include climate change, unsustainable business practices and unsound corporate governance. The guide emphasises that these risks could be financially significant, both over the short and longer term, and says that trustees should decide how relevant these factors are as part of their investment risk assessment. The guide states that trustees may wish to take appropriate action, such as making changes to the investments included in the default arrangement or those offered to members to select, or engaging with the companies in which investments are held.

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The Pensions Regulator gives detailed guidance on what good stewardship on the part of investment managers would look like, and what role trustees can play in these activities. For example, trustees' statement of investment principles (SIP) must include statements on voting rights and the extent to which they take account of social, environmental or ethical factors in the selection, retention and realisation of investments. The guide suggests that trustees may wish to expand these mandatory statements into meaningful policies on key sustainability and stewardship issues.

The Pensions Regulator also recommends that trustees seek information on their members' preferences regarding non-financial factors and socially responsible investment.

Communicating and reporting guide

The communicating and reporting guide sets out ways in which trustees can communicate and engage effectively with their members. Trustees should choose methods that are appropriate and

proportionate according to the size of the scheme and available resources, and are most likely to engage the scheme members. Suggestions for best practice include:

- Tapping in to the trustees' and the employer's existing knowledge about members.
- Member surveys.
- Running workshops or speaking events through the employer.
- Holding a member AGM or inviting members to the scheme's AGM.
- Focus groups or forums to ask for members' views on particular aspects of the scheme and its services.
- Setting up a regular member panel.

The guide also emphasises that communications should be "accurate, clear, relevant and in plain English", and links to the NEST golden rules of communication.[5]

Trustees can assess preferred methods of communication by asking members, member nominated trustees or member representatives, or by looking at available research and considering how it applies to their members.

There is specific guidance on communicating in response to member requests. This confirms that trustees have a duty to disclose certain information when it is requested by members, beneficiaries or unions. This includes, but is not limited to, the chair's statement, the statement of investment principles, the annual report and accounts, and information about scheme processes and service providers. The Pensions Regulator emphasises that trustees are free to go beyond legal minimums and proactively publish this information, or give additional information on request. The guide says that trustees might wish to consider doing this if they are repeatedly asked for certain information, although when disclosing information they should consider commercial sensitivities and confidentiality clauses.

The guide comments that some information, for example voting on equities owned by the scheme, can be dense and complex for members to understand. Trustees might wish to contact the member to understand more about what has prompted their request, and to assess whether a summary or some other information may be more accessible.

This guidance is overdue but welcome. Member requests for information from their pension fund about where their money is invested and how ownership rights are exercised on their behalf often receive an inadequate response, and sometimes receive no response at all.

Disclaimer

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About ShareAction

ShareAction (Fairshare Educational Foundation) is a registered charity that promotes responsible investment practices by pension providers and fund managers. ShareAction believes that Responsible Investment helps to safeguard investments as well as securing environmental and social benefits.

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The opinions expressed in this publication are based on the documents specified. We encourage readers to read those documents. Online links accessed 31 August 2016. Fairshare Educational Foundation is a company limited by guarantee registered in England and Wales number 05013662 (registered address 16 Crucifix Lane, London, SE1 3JW) and a registered charity number 1117244, VAT registration number GB 211 1469 53.

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