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Response to FRC/FCA DP19/1: Building a Regulatory Framework for Effective Stewardship

I am writing on behalf of the **Association of Consulting Actuaries (ACA)** in response to the above-named discussion paper.

Q1: Do you agree with the definition of stewardship set out here? If not, what alternative definition would you suggest?

We agree with the observation in the discussion paper that there are several definitions for stewardship used in the industry. The discussion paper defines stewardship as "the responsible allocation and management of capital across the institutional investment community, to create sustainable value for beneficiaries, the economy and society". Whilst we have no objections to this definition, we do believe that:

- A broadly consistent definition with that used in existing regulation would be useful;
- Bringing the definition to life with examples of stewardship activities, such as those outlined in section 3.1, can help asset owners, in particular, understand how they can integrate stewardship into their investment decision-making process.
- We would also like to ensure that any additional governance requirements are clearly linked to positive outcomes compared – as the DP notes, there is academic research that appears to show the benefits of good Stewardship and it needs to be clear how this can be assessed by asset owners.

Q2: Are there any particular areas which you consider that investors' effective stewardship should focus on to help improve outcomes for the benefit of beneficiaries, the economy and society (e.g. ESG outcomes, innovative R&D, sustainability in operations, executive pay)?

The asset owners that our members provide consulting advice to will be predominantly institutional investors, with the majority being occupational pension schemes. Many are resource (and cost) constrained (including some larger schemes with in-house teams) and therefore we believe a focus on broader ESG factors would be a reasonable way for pension trustees to integrate better stewardship in their investment decision-making process. Whilst other areas provided in the example to the question are relevant, our preference for asset owners is for a less granular approach in order to create flexibility to accommodate the different governance budgets of all trustee boards.

The DWP's 2018 regulations, which require trustees to set out in their Statement of Investment Policy (SIP) how they take financially material considerations, such as ESG factors, in account in the selection, retention and realisation of assets, will help increase the prominence of these issues with pension trustees. In addition, the regulations require trustees to ensure there is a policy in their SIP that sets out their approach to the stewardship of the investments, including engagement with investee firms and the exercise of voting rights, which we believe gives trustees the flexibility in their approach to suit their scheme's requirements and their governance budget.

We would also welcome further research, whether it be from academic institutions or from asset managers, which can be used to demonstrate which of these factors has the greatest benefit for relevant stakeholders. This will then permit asset owners who wish to focus on particular goals to be able to better understand how they should allocate capital to investment managers and interact with them. In particular, we would hope that with time it will be easier for asset owners to see which managers are more effectively adding value from their stewardship activities.

Q 3 : To what extent do the proposed key attributes capture what constitutes effective stewardship Which attributes do you consider to be most important? Are there other attributes that we should consider? If so, please describe.

Section 2.10 (and Table 1) of the discussion paper sets out the key attributes of effective stewardship, being: A clear purpose; constructive oversight, engagement and challenge; institutional culture and structures; and disclosure and transparency. We think this captures the key elements of what effective stewardship is without being too prescriptive.

Having a clear purpose on the approach to stewardship will drive the actions and implementation of the stewardship policy, and therefore we believe this is a key attribute for effective stewardship. For pension scheme trustees, setting out their stewardship policy in the scheme SIP allows the approach to stewardship to be made specific to that particular scheme in terms of the time horizon of the scheme, the nature of the assets in the investment strategy, the expectations of the members and (where applicable) scheme sponsor.

With regards to the other key attributes set out in section 2.1 of the discussion paper, we believe they will only be effective if it is possible for an asset owner to make a (positive) change and this to be clear from the monitoring. Trustees may monitor stewardship activities of the scheme's investment managers but this exercise has no value if the trustees do not do anything with the information. This is more likely to occur if it is difficult to understand if value is being added from the information provided. For example, a list of what actions a manager has taken at AGMs is monitoring but it is very difficult to understand what to do with this information. The investment consultant community needs to help trustees understand the information and provide advice on what action could be taken.

Q4: What do you think is the appropriate institutional, geographical and asset class scope of stewardship? How can challenges associated with issues such as the coordination of stewardship activities across asset classes, or the exercise of effective stewardship across borders, be overcome?

In our view, the key attributes of stewardship, as set out in section 2.10 (and Table 1) of the discussion paper, should apply across all regions and asset classes though the ability for engagement and challenge will vary, and this is a challenge at the asset class level.

It is also important to note that an investment manager with investments in a particular company's stock and bonds may have conflicting views on the company's activities that could have different impacts on equity and debt. The asset managers need to act in the best interests of their asset owners at the asset class level but should be encouraged to disclose where a conflict may have arisen and how they dealt with this. This would help with the regulatory proposal as set out in table 2 under section 6.23 that asset managers disclose to asset owners how the implementation of their investment strategies is consistent with the asset owner's best long-term interests, for example if the asset owner has investments with the same investment manager but in different asset classes.

In terms of exercising effective stewardship across borders, asset owners can look to appoint investment managers that had a reasonable local presence in the regions they were investing in, in order to facilitate engagement and challenge of the issuer and having a good understanding of the local sovereign and regulatory jurisdiction. It should be noted however that this will be easier to accommodate for larger asset managers and as such it would be useful to understand what is considered reasonable based on the resources available to the manager.

Q5: We welcome examples of how firms with different objectives and investment strategies approach stewardship.

From the pension scheme perspective, stewardship has traditionally been approached by delegating voting and engagement activity to investment managers, though the level of monitoring, and actions taken following a review of the monitoring reports, is inconsistent and has typically been driven by larger pension schemes that have an in-house presence. We expect this dynamic to change, particularly in light of the DWP's 2018 investment regulations although we do also note that the quality of the reporting needs to make it easy for Trustee Boards to review and assess quickly and easily.

In particular, we welcome input on how stewardship practices differ across active and index-tracker funds, in the following areas:

i: how firms prioritise and conduct stewardship engagements

ii: what investments firms have made in stewardship resources

iii: how stewardship activity is integrated with investment decisions.

To help pension scheme trustees understand how their investment managers engage in and incorporate environmental, social and governance factors (including stewardship approaches such as voting and engagement) into their investment processes, some investment consultancy firms place a rating on the investment manager as part of the manager research process. This is done at the manager and the asset class/strategy level. Few managers score highly and there is scope for improvement across the investment manager community as a whole.

Whilst active managers may include ESG factors in their investment decision making, portfolio construction and implementation processes, passive managers will focus on voting and engagement and may have a firm wide commitment to ESG by collaborating in initiatives or engaging with regulators, though this varies by firm as noted in the discussion paper. In addition, index tracking funds will typically vote on routine matters rather than complex issues (including many environmental issues).

In our view, an investment house that has a large resource in terms of people focussing on ESG/stewardship does not necessarily translate to a better quality team. The skills and expertise of the individuals in the team are more valuable to guaranteeing effective stewardship.

We also note that the way that most active managers (in liquid markets) implicitly implement a form of stewardship (as noted in the DP) is by selling or not buying assets they do not believe are sustainable long term. This needs to be taken into account when considering if a manager has implemented effective long term sustainability into their investment analysis.

Q 6 : To what extent do you agree with the key barriers to achieving effective stewardship identified in this DP? What do you believe are the most significant challenges in achieving effective stewardship? We would particularly welcome views on the investment required to embed effective stewardship in investment decision-making.

The barriers to effective stewardship noted in 5.2 of the discussion paper include costs, misaligned incentives and the flow of information. From a pension scheme perspective, we see the key challenges for pension trustees as cost constraints and constrained governance budget. The latter covers lack of resource to cover stewardship issues and meeting time to address stewardship, particularly if there are wider funding discussions/negotiations in progress. The DWP’s 2018 investment regulations have increased the focus of stewardship though cost and time constraints will ultimately drive the extent to which trustees will embed stewardship and wider ESG issues in their investment decision making processes.

Better transparency and simple (and standardised) reporting from investment managers, covering an analysis of their stewardship actions carried out on behalf of their investments, will help reduce costs and improve the analysis and engagement from pension scheme trustees.

It can also be difficult when investors use pooled funds as the vast majority of small and medium sized pension schemes do to effectively communicate to investment managers what their requirements/views are on engagement. Particularly when clients are small parts of funds, it can lead to a view that it may not be worth the additional governance time to communicate their wishes to managers as they are only a small investor and the manager cannot give them advantage over other clients. As a result, a way for views to be aggregated more clearly from investors to pooled fund managers would be very beneficial. It does not have to work in the same way as company to shareholder but you could consider the analogy that companies have votes to allow shareholders to express certain views: could managers do more of this via their Fund AGMs, for example.

Q7: To what extent do you consider that the proposed balance between regulatory rules and the Stewardship Code will raise stewardship standards and encourage a market for effective stewardship?

We believe there needs to be a balance between enforcement and voluntary actions. As the Stewardship Code follows a 'comply and explain' approach and builds on the stewardship requirements set out in the SRDII regulations, we feel this is the right approach for both asset owners and asset managers.

In creating a market for effective stewardship, it would be beneficial to ensure that pension trustees can clearly distinguish between the approach of different firms and it is not simply a case of putting in place a suite of policies where it is difficult to work out how and where value is being added. For example, it would be useful if above a minimum standard, investment managers can show clearly how they have made choices between allocating resources to different areas where they best believe it will add value for their investors.

Q8: To what extent are there are issues with proxy advisers that are not adequately addressed by SRD II and proposed revisions to the Stewardship Code?

We do not have any further thoughts with regards to proxy advisers, that have not already been outlined in the discussion paper.

Q9: We welcome feedback on other specific aspects of the regulatory framework described above. In particular, we are interested in views on:

i: Whether and to what extent the FCA's proposed rules for asset owners should be extended to SIPP operators?

We agree that the FCA's proposed rules for asset owners should be extended to SIPP operators too.

ii: The case for regulatory rules to expand the reach of stewardship beyond listed equity

Whilst we are supportive of this proposal, we would suggest that there are clear expectations of what constitutes effective stewardship by asset class, given the difficulty to engage positively with issuers of non-equity assets. The expectations should not be too prescriptive that it creates unnecessary challenges or costs for asset owners, nor too vague that no positive action is taken by the majority of asset owners.

iii: Whether there is a role for UK regulators in encouraging overseas investors to engage in stewardship for their asset holdings in the UK

Encouraging overseas investors to engage in stewardship for their asset holdings in the UK is a positive action though we do not have knowledge of the UK regulators scope and power in this area. We note that overseas regulators have adopted and expanded the UK Stewardship Code to develop their own local code.

We would also note that if strong stewardship leads to improved capital allocation and therefore stronger markets, this should naturally lead to investors who are not covered by the regulations to adopt similar practices.

iv: The extent to which additional rules might be necessary either to improve stewardship quality or prevent behaviours that might not be conducive to effective stewardship

Additional rules may be necessary to consider if the incoming regulations and adoption of the revised Stewardship Code are not effective in enhancing the stewardship behaviours of asset owners, asset managers or issuers, but in our view, not at this time. We also note that if strong stewardship can improve returns for shareholders then it should naturally lead to its greater adoption over the long term. If managers who adopt good practices deliver better capital allocation and strong performance, then we would hope money should flow towards these approaches although we do note that this also means managers need to be able to demonstrate it is the effective stewardship that is creating the benefit.

v: For differences between active and index-tracker strategies in the practice of stewardship, whether there are particular regulatory actions we should consider to address any perceived harms.

The main perceived harm we see in the differences between active and index-tracker strategies is the potential shorter-term focus of some active funds and the underlying asset owners, where too much emphasis is placed on short-term performance.

vi: Whether the FCA’s proposed rules to implement certain provisions of SRD II should apply on a mandatory, rather than ‘comply or explain’, basis.

In terms of disclosure, whether the requirement is mandatory or not, our preference is to ensure there is a standardised way to report that does not require a significant increase in resource or cost from asset owners. For example, pension scheme trustees could share their scheme’s Statement of Investment Principles with asset managers (as some do already) in order to share their long-term investment objectives and policies on stewardship, for example.

Q10: We welcome feedback on whether, to support effective stewardship, we should consider amendments to other aspects of the regulatory framework that affect how investors and issuers interact (such as the LRs, PRs and DTRs)?

We believe that transparency with how ESG factors are taking into account by issuers’ corporate strategies will help improve overall stewardship due to the improvement in the flow of information. In addition, investment managers being required to specify similar policies in their prospectuses will also improve transparency.

We hope that you find the contents of this letter of assistance. We would be happy to discuss them further if that is helpful. Please contact me on 01483 777113 or at vanessa.hodge@mercer.com

Yours faithfully

Vanessa Hodge FIA
Member, Investment Committee
On behalf of the Association of Consulting Actuaries Limited

25 April 2019

About the Association of Consulting Actuaries (ACA)

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and all actuarial advice given is subject to the Actuaries' Code. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of private sector defined benefit pension schemes.

On the investment front, many of our members are asked to advise on scheme investment objectives and on asset allocation strategies appropriate to these objectives, taking into account each particular scheme's liabilities.

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