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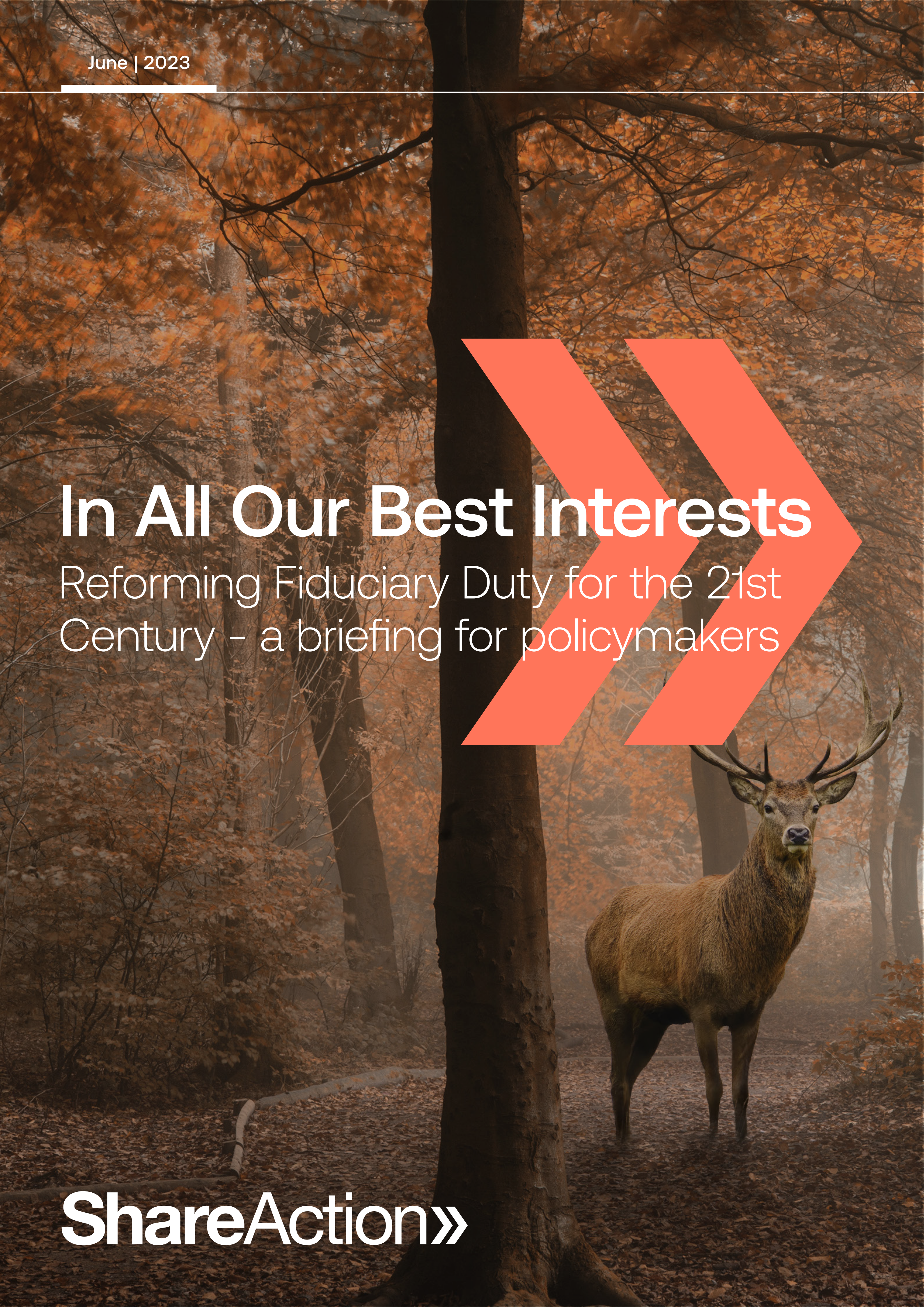

In All Our Best Interests

Reforming Fiduciary Duty for the 21st Century - a briefing for policymakers

ShareAction»

About ShareAction

ShareAction is an NGO working globally to define the highest standards for responsible investment and drive change until these standards are adopted worldwide. We mobilise investors to take action to improve labour standards, tackle climate change and address pressing global health issues. Over 16 years, ShareAction has used its powerful toolkit of research, corporate campaigns, policy advocacy and public mobilisation to drive responsibility into the heart of mainstream investment. Our vision is a world where the financial system serves our planet and its people.

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Summary

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Pensions should provide the means for a good retirement. But quality of life must entail looking beyond solely financial return.

In a time of accelerating environmental and social crises, we now need to see an evolution of the duties of pension trustees. Pension savings should be empowered to contribute to broader societal and environmental goals that are clearly in savers' best interests.

The UK pensions sector is an immensely powerful, growing component of our financial system. UK funded occupational pension schemes[1] alone holds up to £3 trillion in assets under management (AUM)[2]. The decisions made in trustee boardrooms, those who advise them, or who manage investments on their behalf, have huge implications for retirees - both now and in the future. Auto-enrolment has successfully and dramatically increased the number of UK employees saving for retirement., In January 2023, UK private pensions[3] participation alone stood at 15.9 million savers.[4] This has put the future of many people's livelihoods in the hands of the financial system, and a direct stake in how this system impacts on our planet and society.

Fiduciary duties exist to ensure that those managing the money of others act in their best interests. But interpretations of this critical legal principle remain out of step with the needs of today's world- with evidence showing that the management of savers' money is misaligned with a sustainable future.[5]

Recent years have seen a raft of commitments from the UK Government on climate and nature: Net Zero emissions by 2050, halting nature's decline by 2030, and most recently a commitment to protecting 30% of the world's oceans. The financial sector is increasingly being recognised as being integral to achieving these goals – reflected most prominently in the UK's commitment to becoming the world's first net-zero aligned financial centre. But the legal and regulatory frameworks within which the financial sector operates aren't on track to make these commitments a reality. The core objectives of pension funds - and by extension, other actors in the investment chain - remain the same – maximising risk-adjusted returns without enough attention to broader social concerns.

Policymakers have recognised that the existing frameworks around fiduciary duty must be addressed, and the UK Government's 2023 Green Finance Strategy sets out a welcome commitment to engage with stakeholders on the topic.[6] The UK Government must seizes this opportunity to implement meaningful reforms.

ShareAction (formerly, 'Fair Pensions') has examined interpretations of fiduciary duties, and the consequences of this for savers, since the 2008 financial crisis. This briefing builds on previous reports and policy proposals,[7,8] and the ideas proposed in ShareAction's model Responsible Investment Bill.[9] It sets out why now is the time to re-consider and clarify in the law what is meant by acting in the best interests of beneficiaries. We must empower pension schemes truly to act in savers' best interests as they face the challenges of the 21st century.

Box 1: Summary of policy recommendations

Re-define and clarify in law what it means to act in beneficiaries' 'best interests'. 'Best interests' should be considered more broadly than in solely financial terms. It should consider the impacts of decisions on factors that are critical to beneficiaries' quality of life, such as the environment, the financial system and society. It should consider the views of beneficiaries, which are integral to understanding what is in their best interests.

Extend these measures beyond occupational schemes, to cover Local Government Pension Schemes and FCA-regulated schemes.

Develop guidance and accountability mechanisms to support and ensure pension schemes meet their duty to act in beneficiaries' 'best interests', with regards to the above factors, and consider further provisions to ensure the law is supportive of trustees acting in beneficiaries' broader best interests.[10]

Explore further measures to ensure that other actors in the investment chain, such as the investment consultants and asset managers who advise on and manage the investment of pension scheme assets on behalf of trustees, are held to the same fiduciary standards.

The evolution of fiduciary duty – a timeline

Start

October 2005
The United National Environment Programme Finance Initiative (UNEP FI) and law firm Freshfields Bruckhaus Deringer publish the 'Freshfields Report', which argued that integrating Environmental, Social and Governance (ESG) considerations into investment analysis to more reliably predict financial performance is 'clearly permissible and is arguably required in all jurisdictions'

March 2011
ShareAction (then 'Fair Pensions') publish the report 'Protecting our Best Interests: Rediscovering Fiduciary Obligation'

March 2012
ShareAction (then 'Fair Pensions') published 'The Enlightened Shareholder: Clarifying Investors' Fiduciary Duties', proposing aligning the duties of investors' with those of company directors

July 2012
Professor John Kay's government-commissioned review of UK equity markets and long-term decision making was published, revealing concern about the interpretation of investors' fiduciary duties and recommending that the Law Commission review the application of fiduciary duties to pension trustees and their advisors

July 2014
The UK Law Commission completed its review of the law on fiduciary duty

September 2015
The Principles for Responsible Investment, UNEP-FI, UNEP Inquiry and UN Global Compact publish the report 'Fiduciary Duty in the 21st Century'

June 2017
The UK Law Commission publishes its report 'Pension Funds and Social Investment'

September 2018
DWP amends the Occupational Pension Scheme (Investment) Regulations to require pension scheme trustees to state a policy on financially material ESG factors

November 2020
ShareAction publishes the 'Responsible Investment Bill', introducing model legislation to clarify that beneficiaries' best interests go beyond maximising financial return

February 2021
The Pensions Scheme Act 2021 received Royal Assent, setting the groundwork for increased reporting obligations and climate change consideration by trustees

July 2021
The PRI, UNEP FI, the Generation Foundation, and Freshfields Bruckhaus Deringer publish the report 'A Legal Framework for Impact', examining the extent to which investors can invest for sustainability impacts

December 2022
An amendment is tabled to the Financial Services and Markets Bill in the House of Commons, which didn't pass and would have broadened the definition of pension scheme members' 'best interests'. The new definition would include considering the impact of investments on the planet and society, and the views of beneficiaries

March 2023
Government's Green Finance Strategy includes a DWP-led process to clarify fiduciary duty through a series of roundtables and a working group of the Financial Markets and Law Committee

Finish

Why policymakers should reform and clarify fiduciary duty

Why policymakers should reform and clarify fiduciary duty

Many trustees, and by extension, other actors in the investment chain, still frame and understand fiduciary duty through a narrowly financial lens.

Despite some clarification in 2018 as to how trustees ought to deal with ESG factors through amendments to regulations, the law still understands the purpose of pension investments to be solely financial, ignoring the relationship between the financial system and our wider world. As a result, the objectives and activities of pension schemes are still viewed through a narrowly financial lens. This framework is no longer suitable for the challenges that investors and policymakers now face in dealing with existential challenges such as climate change and growing social crisis.

This narrow focus on financial returns is contributing to members' savings not being invested responsibly. This is true both financially, as systemic risks to returns on investment portfolios from environmental and social issues are unlikely to be adequately addressed, and more broadly, by jeopardising savers' chances of retiring into a world that provides them with a good quality of life.

Box 2: Why legislative change is needed

Leading lawyers have argued that the current legal framework allows significant scope for investors to consider sustainability impacts, if they can be considered financially material to the scheme. However, trustees remain hesitant despite previous efforts to clarify the situation. The Association of Pensions Lawyers, in response to a 2021 call for evidence from the Work and Pensions Committee on pension scheme stewardship and COP26, stated that 'without further clarification in the law it is not clear that this [trustees acting in a way likely to lead to broader quality of life benefits for scheme beneficiaries] would be within trustee fiduciary duties'.[11] These doubts cannot be adequately resolved without explicit change to the 'black letter' of the law. Further, in order to move beyond the current narrow financial risk and return lens shaping investment decisions, legislative change will ultimately be required.

Fiduciary duty and ‘financial vs non-financial’ factors

Fiduciary duty and 'financial vs non-financial' factors

When discussing investors' consideration of sustainability, it has become commonplace to assess issues depending on whether they are deemed to be 'financial' or 'non-financial'.

This focus originated from a 2014 Law Commission report which examined the duties of investment intermediaries, which drew a distinction between factors considered relevant to increasing returns or reducing risk, termed 'financial factors', and those which are not, termed 'non-financial factors'. This distinction has subsequently been adopted across UK regulation and guidance, and in wider investment industry discourse and practice.

The Law Commission's report described non-financial factors as those which may influence decisions that might be motivated by 'non-financial' concerns, such as 'improving members quality of life', 'showing disapproval of unethical conduct' or 'improving the UK economy'.[12] This distinction is primarily about the motivation behind which trustees make their decisions.

Leading lawyers have demonstrated that investors do have significant scope within the law as it stands to pursue sustainability goals – as it is clear that many sustainability issues are financially material. It has also been argued that in some cases, the law may actively require them to do so - for example, where pursuing a sustainability goal is necessary in order to achieve financial return.[13 14]

However, this remains reliant on investors understanding these issues as having solely financial motivations, which in practice can inhibit action on sustainability impacts.[15]

In reality, the line between 'financial' and 'non-financial' factors is often artificial. Many issues can have both financial and non-financial elements and motivations, and many factors that some consider to be 'non-financial' will likely become financial over a longer time horizon. Furthermore, the *motivation* for a particular trustee's decision is central; the same factor may be 'non-financial' in the context of one group of trustee's decision-making but 'financial' in the context of another group's, depending on how they are taking account of it.

Recent windfall profits in the fossil fuel industry are a prime example of sustainability issues becoming financial over a long-term time horizon. In 2022, the six largest western oil companies made more money than any year in history.[16] In the short-term, this poses an incredibly profitable prospect for investors, but over the long-term, it's estimated that the risks from global stranded assets in the upstream oil and gas sector could equate to $1tn USD, the financial risk of which will likely be borne substantially by pension savers.[17]

Such a situation can place trustees in a difficult position when faced with foregoing some potential returns in the short-term or in one area of their portfolio in order to take a longer-term view. Further, it is easy to see how such an issue may be placed in the 'non-financial' category if climate change concerns are raised as an ethical or quality of life concern by beneficiaries'.

Other issues are more difficult to place in financial terms, and the law remains particularly unclear about how trustees are permitted or required to act on sustainability factors where financial risk or trade-offs in return are difficult to quantify.

Investments impact on public health provides a useful example. Consider an investee company that profits from producing foods high in salt, fat and sugar. Such a company would negatively impact on broader public health, which is likely to be a 'drag' on the overall economy. It's also likely a trustee may not see this as an issue they are able or obliged to act upon, particularly where this may limit financial returns at the level of the company, or in the short-term. This would be further complicated if these concerns are thought to be influenced by non-financial motivations, such as members views or quality of life.

But this does not mean that investors should not act on such critical issues. Enabling and requiring trustees to consider and take action based on the wider impact of their investments, is key to unlocking the bold action now required.

Fiduciary duty must be reconsidered to enable pension schemes to contribute to broader climate and societal goals in order to act in their beneficiaries' best interests.

It is now widely understood that it is essential that we mobilise the financial system to meet the goals of the Paris Agreement of limiting global temperature rises to 1.5°C above pre-industrial levels. The UK government recognises this, and at COP26 in October 2021, set an ambition for the City of London to become the world's first Net Zero Aligned Financial Centre.

UK financial regulation is slowly beginning to reflect these ambitions. Mandatory disclosure requirements – including requirements for pension schemes to report on their approach to climate-related financial risks and opportunities in line with recommendations from the Taskforce on Climate-related Financial Disclosures (TCFD), and on the alignment of their portfolios with the Paris Agreement - are steps in the right direction.

Yet, research from Make My Money Matter shows that as of November 2022, the largest 20 UK pension funds do not have adequate policies in place to meet net-zero targets. None had explicit policies aiming to end fossil fuel expansion – which the International Energy Agency (IEA) agrees must end to meet the goals of the Paris Agreement.[18] More recent polling from Professional Pensions shows that most schemes still have yet to set net-zero targets.[19] Research from Pensions for Purpose shows that there remains a lack of clarity among trustees about whether addressing climate change falls within their remit.[20]

A sustainable society entails more than just limiting climate change to 1.5C. And whilst some progress has been made on building frameworks to place climate change in financial terms, action on other sustainability issues – particularly social issues, such as working conditions, inequality or population health, lag further behind.

Pension schemes must be required to seek and consider beneficiaries' views, as a way to understand what is in their best interests.

If considering best interests is to move beyond a solely financial lens, schemes must be required to seek, understand, and consider members views, so that they can understand what is in their beneficiaries' best interests.

Currently, schemes most often account for beneficiaries' views by providing alternative investment options, such as switching to an optional 'sustainable' fund. A holistic view of best interests would mean that these views would be considered in the investment activities of the default fund – the fund to which pension savers' money is automatically assigned if they do not select otherwise. Despite surveys showing that most pension savers want impact on people and planet to be considered, savers rarely move funds out of the default option.[21 22 23 24] There are multiple reasons for this which are beyond the scope of this briefing. Crucially, however, only the default option is protected from the pensions charge cap, and the onus cannot be on savers to accept higher charges in order to align with their views on sustainability outcomes.

Leading schemes already make effort to engage with their members in a range of ways: for example, online platforms that allow members to indicate their preferences, surveys, or educational webinars. Such schemes ought to be further empowered in the law to consider these views when making investment and stewardship decisions in the funds in which the vast majority of their members' savings are invested. Schemes who lag further behind on member engagement should be required to seek members' views.

Low member engagement should not be seen as a barrier to this. It is likely that increasing engagement across the board, and allowing members greater say on sustainability could increase engagement, as indicated by recent research commissioned by the Department for Work and Pensions.[25] The soon to be launched pensions dashboard programme presents a key opportunity to support schemes in engaging members on sustainability issues in a centralised and efficient way. New technologies such as Tumelo show underlying beneficiaries the companies they own and facilitate their voting at the AGMs that their pension savings are invested in.[26] Such technology could be integrated into the pensions dashboard to support schemes to engage members without adding undue resource burden.

The UK must act now to reform fiduciary duty and remain a leader on sustainable finance.

Analysis from New Financial estimates that the UK is lagging far behind the EU in terms of the proportion of market activity that may be considered 'green'.[27] Reforming fiduciary duty to enable and encourage pension schemes to make decisions that are in beneficiaries' wider best interests could further support the sector to contribute to UK government commitments on climate and sustainable finance.

As part of the EU Commission's strategy for Financing the Transition to a Sustainable Economy, it committed to clarifying investors' fiduciary duties to reflect the financial sector's contribution to the EU's climate and environmental targets.[28] The EU is now well on the way towards reforming fiduciary duties to better align with sustainability goals – with the regulator EIOPA recommending embedding requirements for pension funds to both consider the impact of their activities on sustainability factors and integrate members and beneficiaries' preferences related to sustainability in their investments.[29]

Requirements to consider the impact of investment activities on sustainability factors are largely embedded across financial regulation in the European Union (EU), beyond just pension funds. For insurers, as of August 2022 this has been not only permitted, but is mandatory within Solvency II regulation.[30]

The UK's sustainable finance agenda has been world leading in many ways, particularly in the Department for Work and Pensions (DWP). The Government's commitment to creating a Net-Zero aligned financial sector, the UK's ambitious Stewardship Code, and the progress made towards action on nature and social factors - through initiatives such as the DWP's Taskforce on Social Factors – currently sets the UK apart. Legal frameworks and the overarching objectives for pension schemes must now be aligned with these ambitions.

Recommendations for policymakers

Recommendations for policymakers

1. Re-define and clarify in the law what it means to act in beneficiaries' 'best interests'.

We propose that policymakers amend the law to include a clarified and expanded definition of beneficiaries' 'best interests'. This approach, building on ShareAction's Responsible Investment Bill, would retain trustee's core duties of loyalty, impartiality and prudence, whilst giving greater latitude to trustees to act on sustainability impacts and incorporate beneficiaries' views. This would also ensure that trustees fulfil their existing duties to consider sustainability-related financial risks and opportunities more comprehensively, by encouraging trustees to act on sustainability impacts that are likely to have systemic financial implications in the long-term.

Box 3: Mirroring company directors' duties

This proposal echoes company directors' duties under section 172 of the Companies Act (the duty to promote the success of the company). This section places duties on company directors to consider the likely consequences of their decisions in the long term, the interests of their employees and the impact of the company's operations on the community and the environment. These provisions would further align the duties of companies' largest shareholders with the duties of their directors. However, recognising that company directors do not face real consequences for failing to comply with section 172 , we propose that stronger accountability provisions accompany this. We support efforts to strengthen section 172, like those proposed by the Better Business Act.[31]

Legislation could entail amending Regulation 4 of the Occupational Pension Schemes (Investment) Regulations 2005 to clarify that all investment functions must be carried out in the best interests of beneficiaries, and to be fair as between the beneficiaries, including as between present and future beneficiaries.

We recommend that the Regulation be amended to introduce a definition of “best interests” as meaning to act in a way that has regard to the following four factors:

A. The likely consequences of any investment activities in the long-term
This would clarify that trustees ought to consider the long-term consequences of investment activities. For schemes that are winding down, and therefore do not have a long time left, we propose that they should still consider the impact of their investment activities for the remainder of members lifetimes, as this is still relevant to the future quality of life of members, and environmental and societal impacts.

B. The impact of any investment activities on the financial system, the economy, communities and the environment
This would broaden what is meant by acting in beneficiaries’ best interests, to reflect that best interests go beyond purely financial factors. In practice, it would require pension funds to consider the impact that their investment activities – both in terms of capital allocation, and in engagement with companies (also known as ‘stewardship’) - have on sustainability factors.

C. Environmental, social and governance risks and opportunities (including, but not limited to, climate change)
This would clarify that fiduciary investors must consider the financial risks and opportunities of environmental, social and governance factors. According to the findings of the Legal Framework for Impact report, investors are already permitted, and in some instances required, to consider these factors within their existing legal duties.[32] However, there remains a lack of clarity about this amongst pension trustees.

D. The views of beneficiaries
This introduces a requirement for trustees to consider the views of beneficiaries when making investment decisions. A duty to consider members views does not suggest beneficiaries will direct investment activities. Rather, it would ensure that schemes seek to understand and incorporate beneficiaries’ views into their decision-making, whilst retaining ultimate discretion.

2. Require trustees' to outline to beneficiaries' the schemes understanding of their 'best interests' and report on how this has guided their decision-making.

This would introduce transparency and accountability to ensure that trustees fulfil their duties. Legislative options include amending Regulation 2 of The Occupational Pension Schemes (Investment) Regulations 2005 to require that Occupational Pension Schemes Statement of Investment Principles (SIP) include an analysis of trustees' understanding of what is in their beneficiaries' 'best interests', and how they will have regard to the factors outlined above.

Implement additional requirements for schemes to report annually to beneficiaries on how they have delivered in their best interests – this could be integrated within schemes existing Implementation Statement obligations, or as a standalone requirement.

3. Extend these duties to trustees' agents – such as investment consultants and asset managers - where they are managing or advising on decisions around how the money of beneficiaries is manages.

The clarified and expanded duties should be extended to intermediaries and advisors, such as investment consultants and asset managers, where they are involved in managing the money of beneficiaries, to ensure that all actors involved in investment activities act in beneficiaries' best interests as they are understood by the scheme.

4. Extend these duties and accountability measures to Local Government Pension Schemes and FCA-regulated schemes.

Local Government Pension Scheme (LGPS) authorities, whilst not trustees, are held to broadly similar obligations as trustees of occupational pension schemes, and when regulatory changes are made for Occupational Pension Schemes, LGPS regulations tend to follow suit. The provisions outlined above could be mirrored through amendments to the Local Government Pension Scheme Regulations. As per The Pensions Regulator and the Financial Conduct Authority's stated regulatory intention that the regulators achieve the same outcomes, these provisions should be mirrored in relevant rules for FCA-regulated schemes.

5. Provide implementation guidance and further support for schemes to operationalise their duties.

The Government and regulators should provide further guidance for schemes on scope and application of their fiduciary duties, to accompany a redefinition of ‘best interests’. Such guidance could address:

- How schemes can ascertain and incorporate the views of beneficiaries, including providing accessible best practice examples;
- Measure schemes can take to ensure that the activities of intermediaries, such as investment consultants, fiduciary managers and asset managers, are congruent with the schemes understanding of their beneficiaries’ best interests.

Centralised mechanisms to support schemes to ascertain beneficiaries’ views should be developed and implemented, for example by including functionality for savers to view underlying investments and express preferences on sustainability issues within pensions dashboards.

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