

FIDUCIARY DUTY CLARIFICATION Q&A

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WHY THIS AMENDMENT IS NEEDED

1. Why does the law need clarifying?

If you talk to pension scheme governance bodies or their advisers about what fiduciary duty requires or permits, you will receive multiple conflicting answers. Many face challenges in answering questions about the extent to which they can or should invest in the UK, whether they should take account of members’ standards of living, the extent to which they can invest for impact, and whether they can take account of members’ views. Their legal advisers are unable to bring clarity because lawyers themselves are not in agreement.

This lack of clarity makes it difficult for pension fiduciaries to understand how to respond to calls from Government to invest in the UK and in UK economic growth, and the extent to which they can invest in solutions which improve member outcomes in other ways - such as through action on climate change, health, infrastructure, the wider environment and skills.

They also face challenges in understanding the extent to which they can act to limit bad outcomes. This means that pension fiduciaries are increasingly being caught on the horns of a dilemma in the courts, where they are taken to be liable for the harms caused by investee firms, but face risks stepping outside a narrow understanding of fiduciary duty if they try to take steps to manage those harms.

We believe that pension fiduciaries need a freer hand to act on these issues where they *wish* to do so, whilst having absolute clarity over the legal requirements they *must* act on. Our proposed changes to the law seek to deliver this, by making clear in law that pension scheme governance bodies:

- have a duty to manage financially material risks and opportunities whatever their source – including specifically those stemming from system-level issues and the impacts of investments, including on members' standards of living; and
- can (but are not required to) take account of the same matters as part of their consideration of the best interests of members and beneficiaries (even where they may not be demonstrably financially material), in addition to members' and beneficiaries' views..

These different terms are explored and defined in answers to questions below.

2. What's wrong with existing Government and Regulator guidance?

Government has issued statutory guidance on complying with requirements around climate change risk management and reporting, and on implementation statements, as well as non-statutory (voluntary) guidance on the Statement of Investment Principles. It has not issued guidance on system-level risks, impacts, standards of living or member views - the topics where we propose clarity is needed.

The Pensions Regulator has issued voluntary guidance on complying with Government legislation on climate change risk management and the Statement of Investment Principles. Its General Code of Practice for trustees does not mention system-level risks, standards of living, investment impacts or member views.

The Financial Conduct Authority and MHCLG have not issued guidance on these matters in relation to personal pensions and the Local Government Pension Scheme either.

In any case, none of these pieces of guidance is a statement of law and so they cannot provide certainty to pension scheme governance bodies about the areas where they can act, or should act. Our proposed legislation aims to resolve that.

3. Isn't guidance from other organisations, e.g. the FMLC and NatWest Cushon opinion, sufficient?

The Financial Markets and Law Committee paper, which focuses on system-level risks, is intended to provide a general explanation for trustees of the legal position in relation to climate change risks, including system-level risks, and the uncertainties and difficulties that exist. The opinion commissioned by NatWest Cushon from Eversheds provides a view on the extent to which schemes can take into account members' standards of living when making investment decisions.

Both are very welcome papers and can be helpful to schemes in the right circumstances. However they are not legally binding and do not cover all areas, schemes or circumstances addressed by our legislative proposals - and the NatWest Cushon opinion has not been published in full.

The Government has said in response to a written question on 24 April that it welcomes the FMLC [report](#), but it has not endorsed it. Even in the event that the Government went further than this by endorsing either or both the FMLC Report and the NatWest Cushion opinion, they would not be legally binding, so this could not give schemes which acted on them protection from litigation, and would not give schemes which were reluctant to follow them any encouragement to do so.

4. Why not get Government or regulators to publish new guidance?

The difficulty with non-statutory guidance issued by Government or The Pensions Regulator is that it is non-binding. A scheme could therefore not defend its investment decisions with complete confidence by pointing to guidance, particularly where the legal position is somewhat unclear (as highlighted by the FMLC report).

Statutory guidance, which trustees and managers must “have regard to” is likewise insufficient on its own to give much-needed clarity in this area. In practice “having regard to” guidance involves the performance of a balancing process, with the guidance being one factor included in the balance. Furthermore, Government currently has no powers to issue statutory guidance with the scope required (see Q5) and (as with non-statutory guidance), such guidance would not be binding.

5 Why isn't it sufficient to change the investment regulations alone?

Government has long had the powers under the Pensions Act 1995 to make regulations about how trustees “exercise their powers of investment”. However it *only* allows them to make regulations. Government does not have powers under that Act or any other Act to issue statutory guidance in plain English on Government's expectations of trustees on matters such as *how* to identify and manage financially material system-level risks or impacts, and *how* they could choose to take account of these matters or members' standard of living, and member views. Without such guidance there would still be legal uncertainty in relying on the letter of the law alone.

Pensions governance bodies need urgent clarification on these points, which only statutory guidance, in tandem with regulations, can provide. Since Government wants to encourage pension schemes to invest more in the UK (going as far as seeking reserve powers to set baseline targets for schemes), and to improve returns to savers - and has to take a new *power* to issue statutory guidance - we believe it should also agree to focusing minds on supporting clarity for governance bodies, by accepting a legal *duty* to bring regulations into force within 12 months of this legislation receiving Royal Assent.

6. Why can't schemes seek their own legal advice or opinions on this?

As explained under Q1, many lawyers have divergent views on fiduciary duty and have arrived at different conclusions. If all 6,000+ UK schemes seek their own legal opinions they will need to pay using employers' and members' money 6,000+ different times and still not arrive at a consensus. Only clarification in statute can provide this.

7. Won't consolidation just sort all this out?

Schemes are consolidating, especially in the DC space, but for the more than 5,000 defined benefit and hybrid schemes this will proceed slowly, with numbers falling by only 3% a year.

Nor are the issues by any means resolved in the largest schemes. There is confusion and uncertainty about whether and if so how to take account of system-level risks and opportunities, standards of living, impacts and members' views in the largest schemes, just as there is in the smallest.

WHAT THIS AMENDMENT WILL DO

8. How will this help pension schemes consider investment in the UK?

It will do this in two ways.

First, taking into account or managing members' and beneficiaries'¹ wider interests enables pension scheme governance bodies to consider not just the value of their pension pot or the monthly income stream, but also factors such as members' and beneficiaries' standards of living. This will facilitate investments which include, but are not limited to, those providing local employment, housing, health, energy and transport infrastructure. It could also include indirect benefits such as investments which enhance the UK tax base, allowing the Government to cost-effectively maintain public services and improve public infrastructure which will in turn support UK growth.

Second, one way in which schemes can take into account or manage system-level risks and opportunities is by making investments which deliver wider benefits to other parts of their portfolio - for example, homebuilding and the delivery of clean energy. Delivery of investments which boost UK economic growth would help to lift all the other parts of the portfolio with significant UK exposure.

However both of these are facilitating measures. Schemes would not be *required* by these proposals to invest more in the UK, only *enabled* to do so. Fiduciaries would retain primacy and discretion in investment decision-making (see Q9).

9. Does this legislation allow Government to direct pension schemes into investing in a particular way? Could Government misuse it?

In contrast to the proposed reserve powers to set targets, our amendment does not give powers to Government to tell schemes how to invest in any way whatsoever.

¹ Members includes active, deferred, pensioner or pension credit members. Beneficiaries are people other than members who are entitled to the payment of benefits under the scheme, typically through nomination by a member.

The duty to manage financially material considerations, whatever their source, is a clarifying measure to ensure that all governance bodies have a shared understanding that these risks and opportunities are to be managed like any other risk or opportunity.

It would not give the current or any future Government the power to tell trustees or other governance bodies to act on matters which were *not* financially material to member outcomes, or to disregard factors which were. In this way, it reinforces the existing principles of investment decision-making, with scheme governance bodies taking decisions independently in the interests of members and beneficiaries.

The other provisions are only permissive, giving fiduciaries a measure of “safe harbour”. They are also constrained by existing investment legal duties – for example, in relation to trustees, the requirements to invest “in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole.”²

Finally, any new statutory guidance issued by Government would only serve to explain regulations. It could not serve as a backdoor to compel pension schemes to invest in, or divest from, particular assets, or countries.

So, our proposed legislation enables and empowers schemes: it provides a clearer legal foundation for acting upon important wider issues within schemes’ investment decision-making. It does not direct schemes to invest in particular assets.

10. Does this mean pension schemes accepting a lower return or savers having a worse income in retirement?

Not at all. In contrast to Government’s reserve powers in the Bill, our proposals do not risk either of these outcomes. They do not amend the core principles of fiduciary duty established through case law -

- Exercising investment powers for their proper purpose - which in the case of a pension scheme means the provision of pension benefits
- Taking account of relevant factors - those which could contribute positively or negatively to anticipated returns, or increase or reduce risk.
- Acting in accordance with the “prudent person” principle - exercising their powers with the “care, skill and diligence” that “a prudent person would exercise when dealing with investments for someone else for whom they feel morally bound to provide”³.

The ability to act on system-level risks, impacts, member standard of living and member views will continue to be limited by these considerations. Fiduciaries would not be permitted to knowingly make investment decisions which prioritised these matters over the purpose of the trust, the consideration of relevant risk and return factors, or the prudent person principle.

² See regulation 4(3) of the [Occupational Pension Schemes \(Investment\) Regulations 2005](#)

³ Re Whiteley (1896) 33 Ch D 347 at 355

For the effect we believe this amendment *will* have, see Q11.

11. What effect will this amendment actually have?

We intend that the amendment will give pension scheme governance bodies much greater clarity over their powers of investment, and give many greater confidence to invest in the way they would wish to, were they clear about what the law requires and what it allows. For schemes that are already active in this area based on their view of the current law, the changes aim to provide statutory support for their current approach, and may empower them to consider new issues as well.

We anticipate this to mean that schemes will have more understanding about their ability to consider system-level considerations, impacts, member standards of living and beneficiary views as part of their consideration of member best interests - as well as the duty to manage system-level risks, impacts and standards of living when they are financially material. This will contribute to lowering risk and enhancing returns

It will also give confidence and understanding about investing in the UK and support UK economic growth, without compromising governance body independence or fiduciary principles.

But it does not require these - it does not set targets or expectations of investing in a particular way.

Therefore, whilst it supports Government policy on enabling more domestic investment by UK pension schemes, it does so in a way which goes with the grain of pension scheme duties and means governance bodies retain primacy and discretion in investment decision-making. Our proposed legislation could, therefore, contribute towards rendering the exercise of any proposed reserve power unnecessary.

Finally, it prompts investment decisions which address these matters, but through a lens which is asset class neutral. A focus on private market assets might inadvertently encourage private equity buyouts of mature companies on the basis that this makes them “productive”, and a focus on UK investments might drive investments in firms with few or no operations in the UK other than a stock market listing. In contrast, our approach encourages investment in firms which deliver the maximum overall benefit for the UK economy, whether listed or unlisted, whether debt or equity and wherever it declares its nominal headquarters - but with all decisions wholly in the hands of pension scheme governance bodies.

12. What does this change mean for advisers and asset managers?

The proposals do not put legal duties onto any advisers or onto asset managers.

Advisers would need to familiarise themselves with the legislation and eventual statutory guidance and advise clients accordingly. Asset managers, as service providers to pension schemes, would find it helpful to understand legislation and guidance, to anticipate changing asset owner priorities, data needs and decisions, and the products and services which will best meet those.

Clarified duties for pension scheme governance bodies would prompt an evolution in investment, stewardship and/or public policy engagement to manage system-level considerations. We anticipate that each of these will prompt an evolution in services, with advisers and investment managers demonstrating an understanding and a track record of successful actions in these areas winning business and developing new services to meet these demands.

Where schemes wish to voluntarily take account of member standards of living, investment- and company-level impacts and member views when interpreting the best interests of beneficiaries, this may also prompt new calls for data, analysis and member engagement or polling.

13. We are already doing all of this/We weren't doing any of this. How will the legislation affect our scheme?

Our proposed legislative change is intended to be a *clarification* of fiduciary duty. It will not make historic decisions litigable since the legislation will not have retrospective effect.

Where schemes have already been taking account of system-level risks, members' standard of living, impacts or members' views, the proposed changes do not imply that they did not have a legal basis for doing so in the past. Indeed, our view is that they did have such a legal basis – the proposed legislation merely aims to ensure that all schemes will gain this understanding.

Where schemes have *not* been taking into account certain financially material risks, enactment of these proposals would not open historic decisions to action in the courts.

Nor should there be any concerns that guidance will cut across existing best practices.

Whilst statutory guidance will likely set out expectations of how schemes undertake the consideration and management of financially material risks and opportunities, schemes who are already managing these matters are free to diverge from the guidance as long as they can explain why they have done so.

Where schemes are already going further than risk management and taking account of system-level risks, beneficiaries' standard of living, impacts or members' views when interpreting members' best interests, statutory guidance will only explain how governance bodies may choose to take account of these factors - it is highly unlikely to cut across any existing scheme practices.

In summary, the proposed draft legislation provides a generally applicable statutory basis for schemes to act, where currently they might be using differing individual interpretations of the general law. The legislation is also flexible, and permissive in key areas, and designed to provide a clearer foundation across the industry, which aims to support - not detract from - current best practice, while empowering others.

SCOPE

14. What pension schemes do these proposals apply to?

Our legislative proposals apply to occupational pension schemes, workplace personal pension schemes (as defined in part 7A of the Financial Services and Markets Act 2000, added by clause 41 of the current Pension Schemes Bill), and the Local Government Pension Scheme (LGPS) .

Whilst workplace personal pensions and the LGPS do not have trustees, the providers and managers of such schemes have expectations which broadly correspond to trustees' fiduciary duty.

The LGPS is managed in a similar way to the trust-based occupational schemes, with administering authorities expected to act in members' interests.

There is a particularly strong case for the Financial Conduct Authority (FCA) to make rules to update the regulatory framework for personal pension schemes, because these schemes are also widely used by employers to comply with their automatic enrolment duties. Furthermore, many firms operate both personal and occupational pension schemes – failing to ensure a common framework risks “regulatory arbitrage”, where companies choose to switch between operating under different regimes based on divergence in regulatory requirements.

15. Do these proposals apply to organisations or trusts other than pension schemes?

The only trusts to which our proposals apply are occupational pension schemes - whether managed by individual trustees or by a corporate trustee. They do not apply to non-pension trusts such as family trusts or charities.

The FCA and the Bank of England may wish to consider extending some of the principles and provisions to other asset owners such as insurers. However this is a matter for them.

16. How do these proposed pension governance body duties compare with those on company directors?

Company directors already have duties under the Companies Act 2006 to - amongst other matters - have regard to the likely consequences of any decision in the long term, the interests of the company's employees, the need to foster the company's business relationships with suppliers, customers and

others, the impact of the company's operations on the community and the environment, and the desirability of the company maintaining a reputation for high standards of business conduct.

This legislation puts pension schemes on a broadly similar footing - adapted to the pension scheme context, by prescribing relevant issues fiduciaries must or may take into account when carrying out investment activities. They seek to do this in a flexible and light touch way, which goes with the grain of pension schemes' existing duties.

TIME HORIZONS

17. Aren't we talking about issues which are too long-term for schemes and savers to worry about?

Not at all.

For example, in relation to system-level considerations, , the financial value of individual investments are affected by the economic, social and environmental conditions in which they are made. Poor transport infrastructure, low housebuilding rates and expensive energy are likely to affect future investment returns and therefore could affect investment values in the short-term, or even today, not just at some point in the distant future.

Similarly the economic, social and environmental impacts of the firms in which pension schemes invest today could be risks affecting those firms, or other firms in the pension scheme's portfolio tomorrow. And foreseeable future risks have an impact on asset values today.

In any case, fiduciary duties also require a forward-looking perspective, and whatever the expected lifetime of the scheme, the duties are to ensure that benefits are paid to members for as long as members are entitled to them. It is right for schemes to be able to take a long-term perspective on the decisions they make today which impact the provision of benefits into the future.

That is why our proposal seeks to amend the misconception introduced by earlier pension legislation⁴ that trustees only need to consider the duration that savers are invested in the scheme (the time "needed for the funding of future benefits by the investments of the scheme"⁵).

⁴ See [regulation 4 of the Pension Protection Fund \(Pensionable Service\) and Occupational Pension Schemes \(Investment and Disclosure\) \(Amendment and Modification\) Regulations 2018](#)

⁵ See [regulation 2\(4\) of the Occupational Pension Schemes \(Investment\) Regulations 2005](#)

Instead our proposal makes clear that the appropriate time horizon is members' and beneficiaries' lifetimes ("the expected remainder of the lifetimes of members and beneficiaries of the trust scheme while benefits that are or were attributable to the trust scheme will be payable").

18. What do these proposals mean for schemes which are buying out, or consolidating?

The time horizon that schemes may take into account for system-level consideration, impacts, standards of living and members' views (and must consider where system-level considerations, impacts and standards of living are financially material risks and opportunities), are the expected remaining lifetimes of members and beneficiaries as long as their benefits are payable.

Schemes intending to buy out with an insurance firm or consolidate with another scheme will obviously be unable to control the receiving insurers' or schemes' strategies far into the future. However our proposals would mean that, where the governing body decides on a receiving firm or scheme, they would need to consider, as part of that decision, the quality of the receiving firm or scheme's management of the whole range of financially material risks and opportunities, and their management of any other factors the governing body wishes to continue to be taken into account. When selecting their new provider, the governing body would need to take account of any assurances that those factors will continue to be considered after the benefits have transferred to the new provider.

19. Will changing the time horizon of schemes which plan to buy out or consolidate affect those plans?

We do not anticipate that clarity about the duty to consider and manage all financially material risks and opportunities over the expected remainder of members' lifetimes would affect DB and DC schemes' or sponsors' decisions or long-term goals to buy out or consolidate.

Our proposal would require governing bodies to take account of these considerations whether the scheme continues and beneficiaries remain members, or the governing body makes the decision to appoint someone else to take responsibility for providing the benefits attributable to the scheme and beneficiaries cease membership.

We cannot envisage any situation in which a scheme which was previously targeting buyout or consolidation would, as a result of this proposed legislation, need to instead consider run-off. The proposals do not favour one approach over another.

FINANCIALLY MATERIAL CONSIDERATIONS

20. What does it mean for fiduciaries to “manage” financially material risks? Is this too high a bar?

Managing financially material considerations does not mean eliminating the risks altogether - “fixing” system-level issues and impacts on members’ standards of living such as housing, public health or climate change - but rather actively managing them down, reducing their likelihood and impact to the lowest residual level that can reasonably and proportionately be achieved.

This is clear from DWP’s climate change governance and reporting regulations⁶ which already require trustees to have processes for enabling them to effectively manage climate risks, as well as having processes for ensuring that people carrying out scheme governance take adequate steps to manage the risks. Accompanying statutory guidance⁷ also requires trustees to have regard to systemic climate-related risks and the opportunities for stewardship to help manage these risks.

None of these duties require trustees or others to “fix” financially material risks.

21. Are you expecting fiduciaries to manage *all* system level risks and impacts?

No, only *financially material* system-level risks and opportunities and impacts that are *relevant to the scheme*.

As explained in Q10, one of the principles of schemes’ fiduciary duties under trust law (with corresponding expectations for managers of the Local Government Pension Scheme and providers of workplace personal pension schemes) is taking account of factors which are relevant to the scheme’s purpose of delivering retirement benefits and could contribute positively or negatively to anticipated returns, or increase or reduce risk. These are the system-level considerations which we propose pension scheme governance bodies should be required to consider and manage.

Occupational schemes already have a duty under 2018 amendments to the investment regulations (alongside earlier changes to LGPS legislation⁸ as well as later FCA rules for Independent Governance Committees⁹) to explain their policy in relation to financially material considerations, including how those considerations are taken into account in the selection, retention and realisation of investments.

We therefore propose that a similar materiality threshold should apply here.

⁶ See [Schedule 1 to the Occupational Pension Schemes \(Climate Change Governance and Reporting\) Regulations 2021](#)

⁷ See paragraph 111 of [Governance and reporting of climate change risk: guidance for trustees of occupational schemes](#)

⁸ See regulation 7 of the [Local Government Pension Scheme \(Management and Investment of Funds\) Regulations 2016](#)

⁹ See section [19.5 of CoBS](#), inserted by [PS19/30 Independent Governance Committees: extension of remit](#)

Materiality will mean different things to different schemes – derisked DB schemes will have a primary focus on managing factors which increase or reduce risk, whilst DC schemes will wish to take more account of factors that contribute positively or negatively to growth, especially earlier in savers' glidepaths. Smaller schemes will tend to be more limited in the actions they can take to manage system-level risks and some impacts – with more reliance on collaboration and delegation – whilst larger schemes will be able to undertake more activities themselves.

However, materiality is a concept that schemes of all types will be familiar with, from pre-existing legislation and established scheme practice.

22. Don't pension schemes already have a duty to manage financially material system-level risks and impacts?

Arguably they do – but we stress “arguably”. The DWP's regulations around the Statement of Investment Principles (SIP) require trustees to set out their policies in relation to “financially material considerations” and do not distinguish between financially material risks and opportunities at company, sector, country or global level, or risks and opportunities stemming from impacts, including impacts on member standard of living. Nor do they distinguish between risks and opportunities identified by different participants.

However, these regulations do not set an explicit expectation of managing these risks and opportunities. Furthermore, system-level and impact considerations require some differences in approach to manage them (see Q25 and Q27).

This has often led to existing duties being misinterpreted to refer only to broad asset allocation decisions, without acknowledging that the returns from many investments are linked by economic, social and environmental circumstances which are common to all of them. Nor has it been uniformly recognised that the impacts of investee companies can “circle back” and constitute financially material risks or opportunities - whether to that company, or to others in the portfolio. Finally, it is not widely understood that it is possible for some schemes to influence members' standard of living in retirement (what the pension will actually be able to pay for), rather than simply meet a nominal retirement promise or maximise the nominal value of the pot.

Without this legislative change there will be a continuing risk of these misapprehensions continuing, missing the opportunities to improve outcomes, whilst lowering risks for sponsors and members. We therefore believe it is worth making clear that pension scheme governance bodies must also consider and manage financially material system-level considerations and impacts, including impacts on member standards of living,

In conclusion, this explicit calling out of less well-understood financially material risks and opportunities is intended to provide a deliberate prompt for pension scheme governance bodies who may have previously concluded that none of these risks and opportunities are financially material to reconsider

them afresh. As all schemes are exposed to the economic and financial forces represented by system-level considerations and the impacts of investee firms, we believe that these matters are sufficiently important for legislation to specify that they must be thought about in their own right.

SYSTEM LEVEL CONSIDERATIONS

23. What do you mean by a system-level consideration?

We are referring to risks and opportunities which cannot be fully managed by diversification of investments alone. Whereas a company-, sector- or country-level risk can be managed by limiting the level of exposure to that company, sector or country, some risks cannot be fully managed in this way, because they are broader.

Most obviously, there are no investments which are unaffected by the rising global temperatures caused by dangerous levels of climate change. Whilst some investments - for example, those operating in drought- or flood-prone areas will be more affected by very high temperatures, the financial risks of climate change cannot be completely managed by selling these holdings. The remaining holdings in the fund would continue to be affected by climate change – for example, through supply chain disruption, scarcity of vital resources and wider economic and social disruption.

This principle applies more broadly than just climate change. Most firms' success will be affected by the extent to which the markets they operate in have healthy and well-educated and -trained populations in adequate housing with good transport infrastructure. To the extent that these conditions are not in place, they will be an inhibitor of portfolio returns, because they will affect multiple companies. And because many of the companies in which pension schemes invest are global, these risks cannot be managed simply by exiting from firms listed in particular markets.

24. What is the difference between system-level risks, systemic risks and systematic risks?

These terms are defined in a variety of ways by different people. The investment academics Jon Lukomnik and James Hawley define systemic risks as the risk to, or arising from, environmental, social or financial systems, whilst systematic risks are the non-diversifiable risk to investments. Often one of these risks leads to another - systemic risks, for example, often create non-diversifiable systematic risk. Risks specific to one investment, in contrast, are often known as idiosyncratic risks.

By "system-level risks" we mean systematic risks. However we have chosen a different, more plain English term, as systematic risks are not always clearly understood and often confused with systemic risks. "System-level risk" is intended to be a more helpful term by indicating that we are interested in

risks which occur above the level of individual firms, sectors or countries, and therefore cannot be *fully* diversified.

25. What can fiduciaries actually do about system-level risks?

System-level risks are not unmanageable just because they are at system-level. There are still actions schemes can take to manage them - as referenced by the UK Stewardship Code principles, which prompt signatories to identify and respond to market-wide and systemic risks, which may include participating in initiatives to support well-functioning financial markets. We identify three broad types of action.

- Stewardship - DWP guidance¹⁰ makes clear that stewardship is an integral way by which trustees should fulfil their fiduciary duty. Company-level engagement and voting can help to manage system-level risks, as well as the risks associated with individual firms. Some asset owners and asset managers carry out stewardship across their whole portfolio to move company norms and market behaviours, thereby managing system-level risks. This type of stewardship often involves communicating expectations for risk management to firms across multiple sectors, followed by activities that use investors' rights to enforce those expectations, escalating as needed.

That sort of engagement is necessarily surface-level given the large numbers of companies involved in a typical portfolio. But more in-depth engagement and voting with firms that have a monopoly- or quasi-monopoly-like position in a market can also affect outcomes across a whole range of other investments, leading to a whole portfolio improvement. Likewise, successful engagement with sector-representative bodies can improve whole portfolio returns where the actions of that sector have a material impact on the performance of others.

- Public policy engagement - more rarely carried out by pension schemes, engagement with Governments is a way in which schemes can manage system-level risks and deliver system-level opportunities. Many outcomes on system-level risks such as climate change are dependent on the strength of Government policy, in setting minimum requirements that industries and sectors must meet.

However, most public policy engagement - via formal consultation, correspondence and informal engagement, is dominated by industry incumbents operating in that sector. The voice of pension fiduciaries is rarely heard. Similarly, decisions on planning policy, and spending on health, education, energy and infrastructure are traditionally contested between a small number of discussants. As investors representing the life savings of tens of millions of UK residents, and often acting as Government's creditors, pension schemes should not be afraid to become participants in these discussions.

Such engagement need not be burdensome. Schemes can collaborate informally, and engage via general or specialist representative membership bodies, or ask those undertaking the day to day

¹⁰ [Climate and investment reporting: setting expectations and empowering savers](#)

management of their investments to engage on their behalf.

- Finally, as explained in Q8, schemes can manage system-level risks through positive investment decisions. Whilst this seems counter-intuitive, because we've defined system-level risks as those which cannot be *fully* managed through diversification alone (see Q26), they can still be *partly* managed. The largest schemes - but also smaller schemes in collaboration - can manage system level risks through investment decisions. For example, they can contribute to managing the system-level risks associated with UK energy costs and security by co-investing in new energy generation.

26. What do you mean by risks and opportunities that cannot be fully managed through diversification alone?

We are defining system-level considerations as risks and opportunities that cannot be *fully* managed through diversification alone to ensure that we capture the right risks and opportunities. As explained in Q8 and Q25, system-level risks can be *partially* managed by investment diversification - for example, investing in new energy generation to manage the system-level risk of high energy prices and energy security. However system-level risks cannot be completely managed by this kind of action. Otherwise they would not be system-level risks at all.

As explained under Q20, we do not propose that schemes should be required to eliminate system-level risks. This phrase is simply being used to define what is meant by a system-level risk. It does not expect or require that governing bodies must completely manage any relevant system-level risk to zero.

IMPACTS

27. What impacts will schemes be required to manage?

The proposed legislation requires governing bodies to consider and manage the reasonably foreseeable and financially material impacts of both the organisations in which they invest and the investments themselves.

This means – where foreseeable and financially material - managing the impacts of firms and other organisations in which they invest and the impact of the pension scheme holding that equity or debt investment.

Many impacts are similar to system-level issues. For example, firms which contribute to action on housing, public health or climate change will have a positive impact which may well feed through into a

financially material opportunity. In contrast, firms which undermine action in these areas have a negative impact, that may present a financially material risk.

Whilst system-level considerations occur at the level of one or more economic sectors, financial markets or economies, impacts can be centred on a small number of companies or even one company. For example a water company which has been responsible for many sewage discharges, including during dry spells, is having a negative impact on people and the environment. This could present a financially material risk to the parent company from litigation or regulatory action. The impact of the scheme being a major investor in that firm could also present a financially material risk.

It will be for the governing body to judge whether these risks are financially material to the portfolio as a whole. Pension scheme governance bodies would not be expected to manage risks or opportunities stemming from impacts which they deem not to be financially material or (obviously) which they cannot reasonably foresee.

However, they would still be free to take account of impacts which are not demonstrably financially material in interpreting the best interests of members and beneficiaries, whilst complying with their wider investment duties (e.g. for trustees investing “in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole”). Governance bodies would not be required to carry out the much-discussed two-stage test set out by the Law Commission¹¹ for non-financial factors. Rather, where they follow a proper decision-making process in line with the general law, this would be sufficient.

28. What can pension schemes do to manage or take account of the impacts of investee firms?

Pension scheme governance bodies will have a broader range of tools to manage or take account of impacts than they will to manage system-level considerations.

As well as the stewardship, public policy engagement and positive investment decisions available for system-level risks and opportunities (see Q25), schemes can also manage financially material impacts at company, sector and country-level through diversification, increasing their exposure to positive impacts, reducing their exposure to negative impacts, and ultimately through exiting from particular parts of the investment universe.

Different impacts will call for different approaches – sometimes traditional asset allocation approaches will be sufficient, whilst some impacts have such wide ramifications they cannot be fully diversified. These latter impacts will constitute system-level considerations.

¹¹ Law Commission: [“Is it always about the money?” Pension trustees’ duties when setting an investment strategy.](#)

STANDARDS OF LIVING

29. Why should schemes be required to take account of member standards of living?

The purpose of the trust is to invest to provide pension benefits. However, the success of the trust in meeting that purpose might be reasonably judged by reference to the real world buying power of that pension, not just its nominal value. Savers who retire into a world of high inflation, where necessary goods such as housing, energy, food or water are disproportionately expensive should be said to have lower pension benefits than they would if the scheme had taken account of those factors and invested to manage (not completely eliminate) those risks.

Some governing bodies may wish to go further and take account of the broader best interests of members and beneficiaries (see Q30).

It is therefore proposed that trustees and other pension governance bodies who wish to take account of members' standards of living should be permitted to do so, within the context of both their wider duties, including for trustees the requirement to invest "in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole". As with other impacts (see Q27), there would not be an expectation of carrying out the "two-stage test" for non-financial factors. Rather, where trustees follow a proper decision-making process in line with the general law, this would be sufficient.

Furthermore, where these standard of living considerations are judged to be financially material (see Q31), scheme governance bodies ought to be expected to manage them.

30. What do you mean by standard of living?

We intend standard of living to have its ordinary meaning. A typical dictionary definition is "a level of subsistence or material welfare of a community, class or person".

However we recognise that some schemes may wish to go further and consider the broader best interests of members and beneficiaries, and the wider value offered by their health, and social and economic well-being, on similar grounds to those set out in Q29. Therefore we have also proposed that schemes be permitted to take these factors into account, whilst meeting their wider investment duties.

31. Will all schemes be required to act on living standards as financially material?

The NatWest Cushon legal opinion, which was prepared on their behalf by Eversheds (but is as yet unpublished), concluded that the trustees of the scheme should take account of member standards of

living where financial materiality could be established. This opinion was tailored to the circumstances of the Cushon scheme, as a £3bn+ and fast-growing defined contribution scheme. More assets under management gives schemes the ability to have more impact on - for example - the costs of necessary goods such as housing, energy, food or water, by making positive investments in them as well as through stewardship and public policy engagement.

However, for many smaller schemes and for larger schemes which are largely derisked, this level of influence will not be possible. Here, managing financially material risks down to the lowest level that can reasonably and proportionately be achieved (see Q20) will mean less opportunity for positive investments, as the scheme's investments may not be enough on their own to affect savers' standards of living. However even smaller schemes can engage with investee companies and governments via general or specialist representative membership bodies, or by asking those undertaking the day to day management of their investments to carry out engagement on their behalf.

MEMBER VIEWS

32. Pension schemes can already take account of member views, why do we need new legislation here?

There is in fact very little clarity on the extent to which pension scheme governance bodies can take account of member views. The Law Commission considered this issue in its 2014 report¹² and developed the concept of a "2-stage test" governing whether trustees could act on a member concern¹³. It required that (1) trustees have good reason to think that scheme members share the concern; and (2) the decision should not risk significant financial detriment.

Government and The Pensions Regulator do both make reference to the 2-stage test in guidance for schemes, and legislation requires schemes to set out their policy in relation to the extent - if at all - to which they take account of member views. However many pensions lawyers have highlighted that the Law Commission's conclusions were necessarily based on limited case law, which predominantly related to charities rather than pension funds. This uncertainty has not been removed for occupational schemes by subsequent cases.

Therefore where pension schemes are minded to take members' views into account, they face legal risks in doing so. This amendment seeks to address those risks by making clear that schemes *can* take account of members' views when interpreting members' best interests. How they choose to do so will be a matter for trustees, informed by Government's statutory guidance.

¹² Law Commission. [Fiduciary duties of investment intermediaries](#)

¹³ We are talking here about investment concerns in relation to which action does not contribute positively or negatively to anticipated returns, or increase or reduce risk. Trustees should manage relevant or "financially material" considerations.

33. Do you want to require schemes to take account of members' views?

No. We intend this measure to be entirely permissive - no scheme would be expected or required to take members' views into account on any matter.

GUIDANCE

34. What should the statutory guidance which you are proposing contain?

Statutory guidance is well-established practice for a range of pensions policy areas, including the implementation statement, cost and charge reporting and climate risk governance. Generally, it is used to set out Government's expectations of trustees in a plain English form - helping to explain the requirements and guide trustees' approach, without compelling particular actions above and beyond those set out in regulations.

Ultimately the content of statutory guidance would be a matter for Government, which would need to consult on draft statutory guidance, but we anticipate that it could cover the following -

- How pension governance bodies could and should identify financially material system-level considerations and impacts (including impacts on members' standards of living);
- How such considerations and impacts could be taken into account, or managed when material;
- Any steps trustees would be encouraged or expected to take before choosing to act on member views; and
- Expectations of schemes which were approaching buy-out or considering consolidation.

35. Will schemes be required to follow the guidance?

Schemes will be required to "have regard" to the guidance. This means that they can diverge from the guidance, but they would need to be able to explain where they have done so.

36. Will the guidance define terms like "reasonably foreseeable", and "standard of living"?

We anticipate that many or potentially all of these will be explained further in guidance. This would be a matter for Government to decide, following public consultation.

Where any terms are not defined, the words or phrases would have their ordinary meaning.

REPORTING AND COMPLIANCE

37. What will scheme governance bodies need to report?

We have been mindful of existing reporting burdens, and have therefore proposed very modest disclosure requirements. These consist of a duty on trustees to set out in the Statement of Investment Principles (SIP) their policy in relation to the consideration and management of the considerations added by this legislation, where they are financially material. We believe that this is appropriate because as a proposed requirement for schemes, Government and regulators need a light-touch way to know that duties are being complied with.

For schemes offering DC benefits, it would also mean trustees need to report on how they have followed their stated policy in their Implementation Statement. However, Government is able to issue statutory guidance on this disclosure, and we would certainly advocate for a pragmatic and proportionate approach.

Corresponding provision could also be made, where appropriate, for workplace personal pension schemes and the Local Government Pension Scheme.

There is already a disclosure in the SIP in which trustees report on the extent to which - if at all - they consider member views. The duties here would not be updated. Trustees would only need to update their SIP if they changed their policy about member views following reassurance from this legislation that they can be taken into account.

The other permissive requirements do not require separate disclosures, over and above the existing requirement in the SIP for trustees to report their policy for securing compliance with the requirements of section 36 of the 1995 Act. This is the existing disclosure by which trustees report their compliance with provision such as obtaining advice and diversification, and would simply require trustees to state whether they take account of, for example, impacts and/or standard of living, or whether they do not.

38. Fiduciaries don't run funds day-to-day, how can they consider impacts and system-level risks?

The proposed requirements to consider and manage financially material considerations would apply equally whether trustees or other pension governance bodies are managing investments or - more commonly - have delegated discretion to investment managers.

Where schemes have delegated to investment managers, governance bodies would look to discuss with their service providers and set consideration of impact and system-level risks in their investment

mandates and incorporate that into manager selection. Trustees would be responsible for ensuring that the delegation was exercised in line with their mandate, and that the appointed manager was considering and managing system-level considerations.

Furthermore, system-level considerations are by definition those that cannot be fully managed through investment diversification, meaning that trustees can still consider and manage these risks and opportunities through stewardship and public policy engagement.

In relation to the taking account of other factors which are not demonstrably financial material, this is permissive. If trustees conclude they do not have the resources or appetite to take account of these, and do not wish to delegate this activity to their fund managers to do so, there is no requirement to do so.

39. How do you stop pension schemes and their consultants from box-ticking?

Many of the provisions in our proposal are permissive. They are designed to enable schemes to act on certain matters where they wish to do so, rather than requiring anyone to invest in a particular way. Therefore we do not propose that these are subject to anything more than the lightest touch in reporting - see Q37 - and as wholly voluntary measures, they cannot be box-ticked.

The requirement to consider and manage financially material system-level considerations and impacts could of course be covered by “boilerplate” text in the Statement of Investment Principles, but trustees would be required to both manage system-level risks and opportunities, and – in the case of schemes with DC benefits - show that they had done so through their Implementation Statement.

Under the proposed amendment, DWP would be able to issue statutory guidance on how trustees should go about identifying, assessing and managing relevant system-level considerations. Divergence from this would need to be explained.

DWP is also already able to issue statutory guidance on the Implementation Statement to ensure that reporting on the management of system-level risks is meaningful and useful (and of course, not disproportionate or burdensome).

UNINTENDED CONSEQUENCES

40. What are the unintended consequences of this proposal?

Any unintended consequences are limited and easily managed.

Schemes which are already carrying out the measures would not need to change their approach. Fiduciaries who would like to do more but have been held back by a lack of clarity would receive more certainty. Where governance bodies are behind the curve on one or more requirements, they would see a clear motivation for action.

The clarified law could accidentally be taken too far in practice, diverting schemes from their single purpose of investing to deliver pension benefits – but pension schemes have already accommodated management of environmental, social and governance considerations and mandatory climate change governance requirements without any evidence of over-interpretation.

Nevertheless to minimise this risk, the language is careful throughout to anchor all of the new relevant considerations to the scheme's core purpose, and not to add additional or collateral purposes. For example:

- Permitted time horizons are based on the expected duration of paying out scheme benefits, not the wider world.
- Mandatory factors are limited to those issues that are financially material. These considerations sit alongside, and so have equal legal status to, the existing statutory investment criteria such as portfolio diversification, security and liquidity.
- Permissive factors are all added non-exhaustively to the factors which schemes may take into account when considering members' "best interests". And the concept of "best interests" itself is still based on achieving the proper purpose of the pension scheme.

Amidst the legitimate concern over unintended consequences of new proposals, we should not forget that the status quo has unintended consequences – fiduciary confusion, unintended regulatory burdens, regulatory risk and costs to schemes, member outcomes and economic growth.