Department for Work and Pensions
Caxton House
Tothill Street
London
SW1H 9NA

Also sent via email to CaxtonHouse.pensiontrustees@dwp.gov.uk.

5th September 2023

Dear Pension Trustees team,

Response to DWP's Pension trustee skills, capability and culture: a call for evidence

We are writing to outline our views on the impact of the way in which fiduciary duties are currently interpreted in practice, including the extent to which trustees are acting in savers' best interests, and make recommendations to government for regulatory reform. The following response is relevant to Chapter 3 of the call for evidence.

In summary:

- Pension fund trustees have a duty to achieve the best outcomes for their beneficiaries
- Outdated legislation is limiting their ability to fulfil this duty and holding back the competitiveness of the UK market
- Legislative and statutory changes would enable pension fund trustees to make more effective investment decisions, whilst maintaining all existing safeguards:
    - Redefine and clarify in law what it means to act in beneficiaries' best interests
    - Require trustees to outline to savers the scheme's understanding of best interests and report on how this has guided their decision-making
    - Ahead of legislative reform, publish statutory guidance on how trustees should consider sustainability impacts
- The effect of these actions would be longer-term wealth creation for savers

Legal context and terminology

Pension trustees are subject to a range of legal, regulatory and contractual duties while acting on behalf of scheme beneficiaries. These include the legislative requirement that pension fund assets must be invested in the 'best interests' of members and beneficiaries and, in the case of a conflict of interest, in the sole interest of members and beneficiaries.[i] Beyond specific legislative requirements, a pension trustee's 'fiduciary duties' are, broadly speaking, to[ii]:

- Exercise investment powers for their proper purpose,
- Take account of relevant financial factors, and
- Act in accordance with the "prudent person principle": the 'care, skill and diligence' a prudent person would exercise, not just when dealing with their own investments, but when dealing with investments for someone else for whom they feel 'morally bound to provide'.[iii]

Since trustees are responsible for beneficiaries' money, a 'relationship of trust and confidence' exists. This means all duties, from all sources, should be considered 'of a fiduciary character' and carried out accordingly. Therefore, we will refer to the full range of duties that trustees are subject to as 'fiduciary duties'.

Best interests need to look at maximising wealth

In January 2023, UK private pensions[iv] participation alone stood at 15.9 million savers.[v] This has put the future of many people's livelihoods in the hands of the financial system. However, interpretations of trustee fiduciary duties remain out of step with today's world – with evidence showing that the management of savers' money is misaligned with a sustainable future.[vi] A climate stress test conducted by the European Insurance and Occupational Pensions Authority (EIOPA) at the end of 2022 'provoked a sizeable overall drop of 12.9%, corresponding to asset valuation losses of some 255 billion euros.'[vii] Yet most pension schemes are informing their members that global warming of 2-4.3°C will have only a minimal impact upon their portfolios.[viii]

Common interpretation of the law still understands the purpose of pension investments, and 'best interests', to be to maximise short-term financial returns – at significant expense to wealth creation over the longer-term. Climate change creates financial risks. These can arise from physical risks, like acute weather events and longer-term climate trends. They can also arise from transition risks – the changes in government policy, technology and consumer preferences required to align our global economy with net-zero.[ix] These risks have the potential to pose such a significant impact that the structural integrity and functioning of the financial system itself is put at risk.[x] At the same time, these financial risks are a reflection of the impacts of climate change that are already being felt and that are predicted to pose an existential threat to every facet of natural and human life – impacts that are, in large part, caused by the activities of companies and governments in which pension funds are invested.

Pension trustees need a legal framework that enables them to manage and respond to these risks. Without it, they are both compromising their ability to pay benefits to their members and, through their investment decisions, jeopardising members' chances of retiring into a world that provides them with a good quality of life.

Bringing the pensions sector in line with UK and international climate and societal goals

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. 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 preindustrial 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.

But the legal and regulatory frameworks within which the financial sector operates aren't designed to enable these commitments. Indeed, they are at odds with them. 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.[xi] More recent polling from Professional Pensions shows that most schemes still have yet to set net-zero targets[xii], while schemes' net-zero transition plans have 'dramatically underestimated' the risks associated with climate change.[xiii] Research from Pensions for Purpose shows that there remains a lack of clarity among trustees about whether addressing climate change falls within their remit.[xiv]

Furthermore, 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'.[xv] It is worth noting that, 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.[xvi] 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.[xvii] Requirements to consider the impact of investment activities on sustainability factors are largely embedded across financial regulation in the EU, beyond just pension funds. For insurers, as of August 2022 this has been not only permitted, but is now mandatory within Solvency II.[xviii]

The opportunity for policy intervention

In the UK, a reframing of pension trustee fiduciary duties would bring the pensions sector in line with climate and societal goals and align with beneficiaries' best interests.

Despite some regulatory clarification in 2018 as to how trustees ought to deal with environmental, social and governance (ESG) factors[xix], the law still frames these factors as relevant if they can be shown to have a short-term material financial impact on specific investments. This makes it difficult for trustees to act in a broader, more holistic way: to factor in the impacts – often longer-term, and more systemic – represented by physical and transition risks, as well as other social and environmental risks, to their overall portfolio. This increases the likelihood that pension schemes are putting savers' money at risk. The law also does not require a trustee to manage the impact of their portfolio on society and the environment, thereby enabling them to invest in a way that jeopardises savers' chances of retiring into a world that provides them with a good quality of life.

It is notable that company director obligations require they 'have regard to' a range of matters including 'the impact of the company's operations on society and the environment' and 'the consequences of any decision in the long-term'.[xx] The UK Government's 2023 Green Finance Strategy sets out a welcome commitment to engage with stakeholders on the topic. Now is the time to seize this opportunity to implement meaningful reforms.[xxi]

Recommendations for policy makers:

Redefine and clarify in law what it means to act in beneficiaries' best interests. Clarify and expand, in law, the definition of beneficiaries' 'best interests' to give greater latitude to trustees to act on sustainability impacts. 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 – including collaboratively, with other schemes – that are likely to have systemic financial implications in the long-term. It would also better align pension trustee investor duties with company director obligations.

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 between present and future beneficiaries), and in doing so have regard to:

> (a) the likely consequences of any investment activities in the long term (including the way in which the investment strategy is consistent with the profile and duration of its liabilities to beneficiaries, and how they contribute to the medium to long term performance of its assets);
>
> (b) the impact of any investment activities on the financial system, the economy, communities and the environment;

(c) environmental, social and governance considerations (including, but not limited to, climate change) which the fiduciary investor considers financially material;

(d) systemic risks, including how the scheme has considered and sought to mitigate systemic risks; and

(e) where appropriate, the views of beneficiaries.

Require trustees to outline to savers the scheme's understanding of 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 schemes' Statement of Investment Principles (SIP) include an analysis of trustees' understanding of what is in savers' 'best interests', and how they will have regard to the factors outlined above.

Additionally, require 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.

Ahead of legislative reform, publish statutory guidance on how trustees should consider sustainability impacts. Guidance to include how trustees consider the likely long-term consequences of investment decisions; the impacts of sustainability risks, including system-level risks; and the impacts of investments on society and the environment. It should also place social factors on an equal footing with climate and wider environmental factors. While guidance would represent a helpful tool for trustees, we remain of the view that it will not be enough to shift the dial to help the pensions sector to adequately act on sustainability impacts. This statutory guidance would therefore be helpful in clarifying for investors the broad range of factors they should consider while acting in savers' best interests, and should be seen as a steppingstone towards, rather than a replacement for, broader legal clarification.

We hope our views are clear. We would be delighted to answer any further questions you may have or to meet to discuss our response in more detail.

Fergus Moffatt
Head of UK Policy, ShareAction

Bella Landymore
Policy and Strategy Director, Impact Investing Institute

About us

The **Impact Investing Institute** is an independent non-profit, established in 2019 as a partnership between the UK government and leading firms in the capital markets. Our ultimate goal is an economy that is socially and environmentally sustainable, and we believe that capital markets need to be part of the solution.

We support investors to put impact at the heart of their commercial investment strategies. Our partners include financial services firms representing a total of c. $14trn AUM, as well as organisations across the business, NGO, social and public sectors. We also work with policymakers and civil society to advocate for impact investing as a powerful tool to unlock solutions to the world's most urgent challenges, like climate change and rising inequality.

ShareAction is a registered charity established to promote transparency and responsible investment practices throughout the financial services sector. We are a member organisation and count amongst our members well-known NGOs and charitable foundations, as well as over 26,000 individual supporters. Among other activities, we work with the financial services sector, including asset management firms, to promote integration of sustainability factors in investment decisions, long-term stewardship of assets and the consideration of the views of clients, beneficiaries and pension scheme members.

---

[i] The Pensions Act 1995 and the Occupational Pension Schemes (Investment) Regulations 2005

[ii] Impact Investing Institute, Impact investing by pension funds: fiduciary duty – the legal context (October 2020)

[iii] Re Whiteley (1896) 33 Ch D 347 at 355

[iv] This figure refers to private sector pensions participation only (not including LGPS schemes)

[v] Review of the Automatic Enrolment Earnings Trigger and Qualifying Earnings Band for 2023/24: Supporting Analysis

[vi] Make My Money Matter (2022). Climate Action Report

[vii] Reuters, Climate change could cost pension funds billions, EU watchdog says (December 2022)

[viii] Carbon Tracker Initiative, Loading the DICE Against Pensions (July 2023)

[ix] Sarah Breeden, Bank of England's sponsor for climate change and incoming Deputy Governor for Financial Stability, speech at the UK Finance Webinar on 1 July 2020

[x] Carbon Tracker Initiative, Loading the DICE Against Pensions (July 2023)

[xi] Ibid

[xii] Professional Pensions, Poll finds many schemes yet to establish net-zero goals (February 2023)

[xiii] Professional Pensions, Scheme net-zero transition plans 'dramatically underestimate' risks (August 2023)

[xiv] Pensions for Purpose, One year on – TCFD reporting for pension funds (2023)

[xv] New Financial, A reality check on green finance (2022)

[xvi] European Commission, Strategy for Financing the Transition to a Sustainable Economy (2021)

[xvii] EIOPA, Consultation paper on technical advice for the review of the IORP II Directive (2023)

[xviii] PRI Blog, Solvency II has some new sustainability impact requirements and they matter for insurers (5 September 2022)

[xix] https://www.gov.uk/government/consultations/pension-trustees-clarifying-and-strengthening-investment-duties

[xx] See Section 172 (d) of the Companies Act (2006)

[xxi] HM Government, Mobilising Green Investment: Green Finance Strategy (2023)