RESPONSE: Pension trustee skills, capability and culture: a call for evidence

Finance Innovation Lab, 4 September 2023

SUMMARY

Echoing ShareAction, the Finance Innovation Lab makes three key policy recommendations in response to the call for evidence:

1. The Government should redefine and clarify in law what it means to act in beneficiaries' best interests.

2. Trustees should be required to outline to savers the scheme’s understanding of best interests and report on how this has guided their decision-making.

3. Ahead of legislative reform, DWP should publish statutory guidance on how trustees should consider sustainability impacts.

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. Beyond specific legislative requirements, a pension trustee’s ‘fiduciary duties’ are, broadly speaking, to:

- 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’.

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 BEYOND SHORT-TERM FINANCIAL RETURN

In January 2023, UK private pensions participation alone stood at 15.9 million savers. 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 the needs of
today’s world – with evidence showing that the management of savers’ money is misaligned with a sustainable future.

Common interpretation of the law still understands the purpose of pension investments, and ‘best interests’, to be to maximise short-term financial returns. This ignores the relationship between the financial system and our wider world: the interplay between economic, social and environmental impacts and longer-term risk-adjusted returns.

Systemic risks, such as climate change and inequality, impact returns on investment portfolios; and investment portfolios have impacts on climate, nature and society. (This is commonly referred to as ‘double materiality’.) These risks may affect multiple sectors or have the potential to pose such a significant impact that the structural integrity and functioning of the financial system itself is put at risk. Without a legal framework that facilitates investors to understand and, where possible, manage these impacts, they are jeopardising savers’ chances of retiring into a world that provides them with a good quality of life.

ENABALING THE PENSIONS SECTOR TO CONTRIBUTE TO BROADER CLIMATE AND SOCIETAL GOALS IS IN SAVERS’ BEST INTERESTS

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. More recent polling from Professional Pensions shows that most schemes still have yet to set net-zero targets, while schemes’ net-zero transition plans have ‘dramatically underestimated’ the risks associated with climate change. Research from Pensions for Purpose shows that there remains a lack of clarity among trustees about whether addressing climate change falls within their remit.

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’. 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. 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. 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.

In the UK, pension trustee fiduciary duties need to be reframed to enable pension schemes to contribute to broader climate and societal goals in order to act in their beneficiaries’ best interests. 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’. The UK Government’s 2023 Green Finance Strategy sets out a welcome commitment to engage with stakeholders on the topic. Government must seize this opportunity to implement meaningful reforms.

POLICYMAKERS MUST INTERVENE

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.

Despite some regulatory clarification in 2018 as to how trustees ought to deal with environmental, social and governance (ESG) factors, 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.

Ultimately, the lack of a legal framework that enables investors and policy makers to manage and respond to these risks may compromise the ability of trustees to pay benefits in the long term. More broadly, by not requiring the management of a portfolio’s impacts on society and the environment, the legal framework is actively jeopardising savers’ chances of retiring into a world that provides them with a good quality of life.

RECOMMENDATIONS

The government should redefine and clarify in law what it means to act in beneficiaries’ best interests. The government should amend the law to include a clarified and expanded definition of beneficiaries’ ‘best interests’, giving 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.

**Trustees should be required 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.

DWP should also 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.

**Ahead of legislative reform, DWP should publish statutory guidance on how trustees should consider sustainability impacts.** This should 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.