

= Protecting our Best Interests

Rediscovering Fiduciary Obligation

“The actual owners of the world’s corporations are no longer a few wealthy families. They are the huge majority of working people who rely on today’s largest companies to safeguard their pensions and life savings.”

- ‘The New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda’

Millions of ordinary savers depend heavily for their future wellbeing on the small number of people who look after their money. The behaviour of these intermediaries is crucial to our ability as a society to respond to today’s key policy challenges:

- **The ageing society.** With the decline of final salary pension schemes, people’s standard of living in retirement increasingly depends on the performance of their pension investments.
- **Climate change.** The behaviour of institutional investors will have an enormous impact on our chances of making the transition to a low-carbon economy.
- **A strong economy.** If we are to return the economy to stable and sustainable growth and prevent another financial crisis, it is vital that our money contributes to good corporate governance rather than fuelling bubbles and irresponsible practices.

What is fiduciary duty?

When one person is entrusted to act on behalf of another, it is vital that strong legal protections are in place to make sure they act in good faith and do not behave in a reckless, irresponsible or self-interested way. These protections are known as fiduciary duties. The financial system is based on lending and investing other people’s money - and savers are particularly vulnerable to the intermediaries who do this. For this reason, fiduciary duty has been described as “the foundation of our capital markets.”

Fiduciary duty speaks directly to post-financial crisis concerns about accountability in financial services, whether it be escalating levels of pay or conflicts of interest which may hurt consumers. There is an urgent need to take debates on financial reform beyond bankers’ bonuses and refocus on the millions of ordinary people whose money is at stake through pensions and other investments. Fiduciary duty is precisely about the obligations owed to people by their agents in the City. It offers a positive agenda for reform, helping to ensure that the financial system acts as the servant of the economy and not its master.

Yet there are two key problems with the current framework:

- Lack of clarity over who owes these fiduciary duties
- Outdated interpretations of what investors’ legal obligations require

= Who looks after our money?

Interpretations of fiduciary duty have yet to catch up with the complexity of modern financial markets. Pension fund trustees increasingly delegate key decisions to external asset managers, taking advice from investment consultants. Yet there is no consensus on whether these managers and consultants share trustees' strict legal duties. In addition, more and more savers are moving into pension arrangements with no trustees, which lack the protection of a clearly-recognised fiduciary relationship.

KEY FINDINGS

- There is serious confusion about the legal duties of the various financial intermediaries who manage savings and investments, with little or no legal authority or regulatory guidance.
- Many UK asset managers describe themselves as fiduciaries, but understanding of what this actually means is often poor.
- The idea of a fiduciary as someone who puts their client's interests above their own sits uncomfortably with the sharply divergent fortunes of savers and financial intermediaries in recent years. From 2002-2007, pension funds' payments to intermediaries rose by over 50%, while annual real returns averaged just 1.1%, significantly lower than in previous decades.¹
- There are serious imbalances in the regulatory framework for different types of pension saving, creating a real risk that savers' level of consumer protection may vary arbitrarily depending on the way their savings are structured (see below).

“ There has been a shift from the traditional model [of capitalism] that applied when I grew up, in which the rewards of investing went primarily to those who put up the capital and who took the risks - to one where the spoils increasingly go to financial intermediaries.”

- Douglas Ferrans,
Chairman, Investment
Management
Association

The Pensions Lottery

Traditionally, most private pensions were workplace schemes with a board of trustees. Today, more and more people are saving for a pension through insurance firms. Here there are no trustees to champion savers' interests: they are protected only by their contract with the firm.

In countries where the 'trust' does not exist as a legal form (such as South Africa), all pension providers are subject to the same legal framework.² In the UK, the system is fragmented. Trust- and contract-based providers are subject to different laws, and are governed by different regulators (The Pensions Regulator and the FSA) with different priorities.³

A saver whose employer offers a trust-based pension is therefore subject to completely different legal protections and accountability mechanisms from a saver who buys a pension product from a high-street provider. Most savers are unaware of this.

KEY RECOMMENDATIONS

- Government and regulators should clarify the legal status of all agents involved in managing savings and investments, including asset managers, investment consultants and insurance firms.
- In its review of financial regulation, the Treasury should ensure that the regulatory structure is streamlined and delivers equal protection to all pension savers.

= The enlightened investor

But it is not enough to ask who holds fiduciary duties. There is also an urgent need to address misunderstandings of fiduciary duty which are holding back efforts to promote long-term, sustainable growth and the transition to a low-carbon economy.

KEY FINDINGS

- Many investors still wrongly assume they are legally obliged to seek the maximum possible return and to ignore 'non-financial' considerations, such as sustainability or their members' ethical views.
- In practice, far from delivering better returns, this can lead to short-termist and imprudent investment strategies which neglect the long-term interests of younger savers.
- Interpretations of fiduciary duty may also worsen systemic risk. Trustees often feel obliged to follow the lead of other investors or risk liability. This may exacerbate market tendencies towards 'herding behaviour' and hold back progress on new issues such as sustainability.
- Pension funds receive around £33.6bn per year⁴ in tax relief. There is a clear public interest in ensuring that these subsidised savings offer good value for savers rather than simply becoming a subsidy for the investment management industry, and that they are not invested in a way which destabilises the economy.

Short-termism: Key facts and figures

- In 1940, the average holding period for US shares was seven years; by 2007 it was just seven months.⁵
- Some equity funds being marketed to UK pension schemes have turnover levels of more than 300% per year.⁶
- In a 2008 study, European pension funds estimated their ideal investment horizons at 23 years, and their actual investment horizons at just six years.⁷
- Company directors report feeling under pressure from their shareholders to maximise short-term profits. In a 2004 US study, 78% said they would prioritise this even if it meant sacrificing long-term business success.⁸

Companies and investors: mismatched obligations?

UK company directors are required by the Companies Act to promote the success of the company, 'having regard' to environmental and social issues and to the long-term impact of decisions. There is a clear mismatch between the ethos of 'enlightened shareholder value' underpinning these duties and the perception of shareholders themselves - including pension funds - that their fiduciary duties legally prevent them from taking an enlightened approach. This mismatch must urgently be rectified if we are to restore the economy to stable and sustainable growth.

KEY RECOMMENDATION

BIS should introduce an 'enlightened fiduciary' provision for institutional investors that parallels directors' duties under the Companies Act. This would clarify that the law does not require fiduciary investors to pursue short-term profit at any cost, but rather to look after savers' long-term interests with regard for the wider consequences of their decisions.

= Further information

This briefing is based on FairPensions' new report, 'Protecting our Best Interests: Rediscovering Fiduciary Obligation'. The report is the outcome of a year-long research process in partnership with Cass Business School and has been supported financially by the Nuffield Foundation. The full report is available online at:

fairpensions.org.uk/fiduciaryduty

For more information or to request a hard copy, please contact:

Christine Berry | Policy Officer
christine.berry@fairpensions.org.uk | 020 7403 7833

ABOUT FAIRPENSIONS

FairPensions is a registered charity established to promote Responsible Investment (RI) by pension schemes and fund managers, and to ensure that ultimate beneficiaries are well served by institutional investors and other professional agents in the investment world.

RI most often entails engagement with investee companies, including through the exercise of shareholder rights, to ensure that extra-financial issues which pose potential financial risks are monitored and managed.

FairPensions is a member organisation whose members include various organisations representing pension savers, including the National Federation of Occupational Pensioners, UNITE and Unison, as well as thousands of individual pension fund members.

-
1. Woolley, P. 'Why are financial markets so inefficient and exploitative - and a suggested remedy', in LSE, 2010, 'The Future of Finance': p135 (online), p121 (hard copy).
 2. See FairPensions, 2011, 'Protecting our Best Interests: Rediscovering Fiduciary Obligation': p48 for more information.
 3. See *ibid* p51-52 for more information.
 4. Calculated from figures available at www.hm-treasury.gov.uk: see FairPensions 2011, p123 for full details.
 5. Haldane A., 2010, 'Patience in Finance', p16.
 6. Based on Simplified Prospectuses of equity funds; further details available on request.
 7. Hesse, 2008, 'Long-term and sustainable pension investments: A study of leading European pension funds', p44.
 8. Graham et al, 2004, 'The Economic Implications of Corporate Financial Reporting', p2.

Fairshare Educational Foundation is a company limited by guarantee registered in England and Wales number 05013662 (registered address Unit TR.G.03 The Leather Market, Weston Street London SE1 3QB) and a registered charity number 1117244.