

Rt Hon Frank Field MP
Chair
Work and Pensions Committee
House of Commons
London
SW1A 0AA

Dear Mr Field

Defined benefit pensions inquiry

Executive summary

- We believe there is a pressing need for schemes to take account of longer-term risks, such as those associated with environmental, social and governance (ESG) factors. Despite the numerous examples of poor corporate practice on ESG having an effect on investor return, survey evidence indicates that many trustees and fund managers do not think of ESG factors as relevant to their investment decisions.
- We believe that many pension schemes do not do enough to challenge short-term investment horizons, or to properly embed consideration of ESG risks into their investment decisions and their mandates for asset managers. Since these kinds of risks are likely to manifest themselves over the longer term, their impact is likely to disproportionately affect younger savers.
- There is a perception that ESG-focused investment is an optional extra that comes at additional expense, and this may be preventing DB pension schemes from taking longer-term issues into account.
- Many trustees do not appear to have the skills to adequately track the extent to which their asset managers monitor and manage long-term risks such as climate risk. The legal duties of pension fund trustees to act in the best interests of members, to exercise "prudent" investment behaviour and to balance risks against returns cannot be wholly delegated to fund managers. Trustees retain supervisory and overall strategic decision-making power. It is concerning that some trustees do not appear to have the skills or resources necessary to undertake crucial aspects of their duties.
- We recommend that the Government amends the Occupational Pension Schemes (Investment) Regulations 2005 to more clearly reflect the conclusions of the Law Commission that ESG factors can be financially material and should be considered as part of pension trustees' fiduciary duty.
- We recommend that the Pensions Regulator (and other relevant regulators) should take steps to educate investment decision-makers on climate risk and other key ESG issues. In particular, this should cover why they should be considered and what steps can be taken to assess and manage the relevant risks.
- We recommend that the Government amends the Employment Rights Act 1996 so that MNTs have the right to request reasonable time off work to fulfil their duties, particularly in relation to skills and knowledge training.

Introduction

1. I am writing to respond to your inquiry on defined benefit (DB) pensions on behalf of ShareAction, a registered charity established to promote transparency and Responsible Investment (“RI”) practices by pension funds and other institutional investors. We are a member organisation and count amongst our members well-known NGOs and charitable foundations, as well as over 35,000 individual supporters.
2. This inquiry is welcome and timely. As acknowledged in the Pensions Regulator’s 2015 *Trustee Landscape Quantitative Research*,¹ the pensions landscape is going through the greatest period of change in generations. UK DB schemes are dealing with large deficits, hitting a record £1 trillion in August 2016,² and are obviously under the spotlight due to difficulties faced by high profile schemes such as Tata Steel and BHS.
3. While fully acknowledging the severity of the present difficulties faced by many DB schemes, our response to this inquiry focuses on the pressing need for schemes to take account of longer-term risks, such as the financial risks associated with climate change. The ex-Law Commissioner who led the Law Commission’s 2014 review of fiduciary duty,³ David Hertzell, warned at an event hosted by ShareAction and ClientEarth in July that pension schemes need to stay vigilant, as the economic consequences of the result of the UK’s referendum on EU membership threatens to draw attention away from longer-term concerns such as climate risk. He said: “In the short-term I think it is a fair assumption that trustees and indeed all involved in the investment chain are going to be much more concerned about volatility and economic issues than they will be about long-term risks such as climate change. That is unfortunate.”⁴
4. This is borne out by the results of a recent survey we worked to develop with Professional Pensions,⁵ which found that only 21% of 101 trustee and pension investment professional respondents had fully embedded environmental, social and governance (ESG) issues into their investment approach. 39% said they do not take ESG factors into account and are not considering doing so. Given the numerous examples of poor corporate practice on ESG having an effect on investor return – the recent example of Sports Direct being just one – it is really concerning that many trustees and fund managers still think of ESG as an optional, ‘ethical’ extra. As the Pensions Regulator’s executive director for regulatory policy recently stated, trustees need to “wake up and smell the coffee” on ESG.⁶
5. The survey also found that 53% of respondents did not think climate change poses financially material risks to their portfolios or those of their clients. A further 16% of respondents did not know whether they thought climate risk was financially material to their portfolios or those of their clients. This year’s Association of Member Nominated Trustees

¹ The Pensions Regulator. (October 2015). *Trustee Landscape Quantitative Research: A report on the 2015 Trustee Landscape research*. Available online at: <http://www.thepensionsregulator.gov.uk/docs/trustee-landscape-quantitative-research-2015.pdf> [accessed 9 September 2016].

² Hymans Robertson. (August 2016). “UK Defined Benefit deficits hit £1 trillion as the Government faces setbacks trying to buy back £60bn of gilts”. Available online at: <https://www.hymans.co.uk/news-and-insights/news-and-blogs/news/uk-defined-benefit-deficits-hit-1-trillion/> [accessed 9 September 2016].

³ The Law Commission. (July 2014). *Fiduciary Duties of Investment Intermediaries*, p.95. Available online at: http://www.lawcom.gov.uk/wp-content/uploads/2015/03/lc350_fiduciary_duties.pdf [accessed 1 September 2016].

⁴ ShareAction. (July 2016.) ‘Investors must not let Brexit divert them from climate risk, says commercial legal expert’. Available online at: <https://shareaction.org/press-release/investors-must-not-let-brex-it-divert-them-from-climate-risk-says-commercial-legal-expert/> [accessed 23 September 2016].

⁵ Professional Pensions. (August 2016.) ‘Climate change is ‘overblown nonsense’ and not a material risk, says industry’. Available online at: <http://www.professionalpensions.com/professional-pensions/news/2468851/climate-change-is-overblown-nonsense-and-not-a-material-risk-says-industry> [accessed 23 September 2016].

⁶ The Pensions Regulator. (September 2016). *TPR: Trustees must wake up and smell the coffee on ESG*. Available online at: <http://www.professionalpensions.com/professional-pensions/news/2470190/tpr-trustees-must-wake-up-and-smell-the-coffee-on-esg> [accessed 9 September 2016].

(AMNT) survey indicated that trustees believe climate change is the lowest risk for their schemes. Only 1% of respondents said climate change is the highest threat to their schemes, in contrast to the 2015 survey where it was ranked as the second top concern with 16% of MNTs calling it their biggest worry.⁷

6. This is despite comments in 2015 from the Governor of the Bank of England, Mark Carney, that “[t]he exposure of UK investors... to these shifts is potentially huge... The challenges currently posed by climate change pale in significance compared with what might come... once climate change becomes a defining issue for financial stability, it may already be too late.”⁸ Reports from sources such as The Economist Intelligence Unit⁹ and Citigroup¹⁰ have indicated that a scenario of 6°C warming could lead to a present value loss of US\$13.8 trillion of manageable financial assets, roughly 10% of the global total (i.e. total stock of assets held by non-bank financial institutions) and, at the same time, that if the investment system does not take steps to move towards a low-carbon economy, then it could be left with as much as US\$100 trillion in "stranded" fossil fuel assets by 2050. We have just published a report in collaboration with ClientEarth, *The hot debate on climate risk and pension investments: Does practice stack up against the law?*¹¹ which states that the failure of many pension funds to adequately assess and manage climate risk may leave them in breach of their legal duties to beneficiaries.

Whether the current framework is generating inter-generationally fair outcomes

7. One aspect of pension savings which is likely to disproportionately impact younger generations is the extent to which pension funds invest responsibly for the long-term.
8. ShareAction has campaigned for Responsible Investment for the past decade. A Responsible Investment approach takes ESG issues into account when undertaking analysis and making financial decisions, and recognises that long-term prosperity requires a move away from short-term profit as the only definition of value.
9. As previously explained, with a few notable exceptions, we believe that pension schemes do not do enough to challenge short-term investment horizons, or to properly embed consideration of ESG risks into their investment decisions and their mandates for asset managers. Since these kinds of risks are likely to manifest themselves over the longer term, their impact is likely to be most keenly felt by today’s savers.
10. It has sometimes been suggested that fiduciary duties require investors to focus solely on financial returns, particularly over the short-term, meaning they cannot consider ESG factors. In this context it is particularly disappointing that the Department for Work & Pensions announced in November last year that following a consultation it had decided not to amend

⁷ Professional Pensions. (September 2016.) ‘AMNT: Climate change scores lowest on biggest risks facing schemes’. Available online at: <http://www.professionalpensions.com/professional-pensions/news/2471723/amnt-climate-change-scores-lowest-on-biggest-risks-facing-schemes> [accessed 23 September 2016].

⁸ Carney, M. (September 2015.) ‘Breaking the tragedy of the horizon - climate change and financial stability’. Available online at: <http://www.bankofengland.co.uk/publications/Pages/speeches/2015/844.aspx> [accessed 23 September 2016].

⁹ The Economist Intelligence Unit. (2015). *The cost of inaction: Recognising the value at risk from climate change*. Available online at: https://www.eiuperspectives.economist.com/sites/default/files/The%20cost%20of%20inaction_0.pdf [accessed 23 September 2016].

¹⁰ Citi GPS: Global Perspectives & Solutions. (August 2015). *Energy Darwinism II: Why a low carbon future doesn't have to cost the earth*. Available online at: <http://climateobserver.org/wp-content/uploads/2015/09/Energy-Darwinism-Citi-GPS.pdf> [accessed 23 September 2016].

¹¹ ShareAction and ClientEarth. (September 2016.) *The hot debate on climate risk and pension investments: Does practice stack up against the law?*. Available online at: <https://shareaction.org/wp-content/uploads/2016/09/ClimateInvestmentDuties-InvestorReport.pdf> [accessed 9 September 2016].

the Occupational Pension Schemes (Investment) Regulations 2005 (the Investment Regulations) to more clearly reflect the conclusions of the Law Commission that ESG factors can indeed be financial factors and should be considered as part of fiduciary duty.¹² Given that the draft Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 have been updated with the appropriate terminology and are due to be laid before Parliament in the near future, we recommend that the Government takes this opportunity to equalise pension investment legislation by amending the Investment Regulations.

11. Failure to address the challenge of climate change not only risks extremely negative impacts on investment portfolios, pension returns, the environment and the wider economy, it also represents a missed chance to benefit from the opportunities offered from a transition to a low-carbon economy – a risk that will again disproportionately affect younger savers. Indeed, we believe that as long-term stewards of individuals’ savings pension funds have a unique perspective and, arguably, a duty, to invest in a way that reflects all of their beneficiaries’ best interests – financial and their wider interest in a healthy environment, thriving economy and decent society.

The balance between meeting pension obligations and ensuring the ongoing viability of sponsoring employers

12. In the course of interviews for our 2016 report *The hot debate on climate risk and pension investments: Does practice stack up against the law?*¹³ one pensions lawyer at a City firm said that she believed that pension schemes face additional investment costs if they take account of ESG factors such as climate risk in investments, and that this could not be justified from a legal perspective for DB schemes unless there were direct financial benefits for the employer.¹⁴ 12% of survey respondents felt that the additional expense of investment was the main reason climate risk was not being taken into account in pension investments.¹⁵
13. We fundamentally disagree with this analysis because we believe that over the time-horizon of most pension schemes ESG factors such as climate change are very likely to be financially material. We are deeply concerned that there is a perception that ESG-focused investment is an optional extra that comes at additional expense, and that this may be preventing DB pension schemes from taking longer-term issues into account. The exposure of pension funds to long-term risks such as climate risk is likely to have a much more significant financial impact on the viability of sponsoring employers than any small increase to the cost of investment at the present time.
14. The Economist Intelligence Unit’s 2015 report on the cost of inaction on climate change states: “Thirty years is a common time frame for pension funds and other long-term investors. But if investors wait until these risks actually manifest themselves, then the options they will have to deal with them will be significantly reduced. This is a vital concern, as the scope of investments available to a future portfolio will be more limited in a world with severe climate change than in one which has successfully mitigated climate risks. This means that future pensioners may see the security of their retirement jeopardised as a result

¹² Department for Work and Pensions. (November 2015.) *Better Workplace Pensions: Reducing regulatory burdens, minor regulation changes, and response to consultation on the investment regulations*. Available online at: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/476447/reducing-regulatory-burdens-and-misc-regs-nov-2015-consultation.pdf [accessed 23 September 2016].

¹³ ShareAction and ClientEarth. (September 2016.) *The hot debate on climate risk and pension investments: Does practice stack up against the law?* Available online at: <https://shareaction.org/wp-content/uploads/2016/09/ClimateInvestmentDuties-InvestorReport.pdf> [accessed 9 September 2016].

¹⁴ *Ibid*, p8.

¹⁵ *Ibid*.

of the climate risk that the asset managers charged with their investments are currently carrying".¹⁶ Pension funds need to take steps to assess and manage climate risk at the present time, rather than wait until the effects of climate change become so extreme as to be unmanageable.

The role and powers of pension scheme trustees

15. We have identified a certain confusion concerning the legal position where trustees delegate to their asset managers. During the course of our research for our 2016 report *The hot debate on climate risk and pension investments: Does practice stack up against the law?*¹⁷, one lawyer commented that many trustees do not have the skills to adequately track the extent to which their asset managers monitor and manage long-term risks such as climate risk. In answer to a question about how far ESG factors such as climate risk are taken into account in investments, one survey respondent said, "It is a factor in manager selection but beyond that we depend on managers for individual decisions" and another commented, "We use fund managers and get comfortable they have strong governance". However, pension fund trustees' legal duties to act in the best interests of members, to exercise "prudent" investment behaviour and to balance risks against returns cannot be wholly delegated to fund managers. Trustees must still comply with these duties when undertaking the functions that have not been delegated. The day-to-day investment decisions, such as the types of investments to hold, may be delegated to asset managers but trustees retain supervisory and overall strategic decision-making power. This normally includes determining the overall investment objectives and making strategic investment decisions, such as the risk/return profile appropriate to the membership, and the proportion of investments to hold to achieve this. Trustees also retain legal responsibility for monitoring fund managers. They will be held responsible for the acts or defaults of asset managers if they have not taken all reasonable steps to satisfy themselves that their asset managers: have the appropriate knowledge and experience to manage scheme investments; are carrying out their work competently; and are complying with the Investment Regulations. At the July event hosted by ShareAction and ClientEarth, Frances Lawson, barrister at Six Pump Court, said that, as a minimum, trustees need to do the following to show they have taken reasonable steps to manage climate risk:

- obtain specialist advice on climate risk;
- assess the exposure of their portfolio to climate risk;
- incorporate a climate risk management approach within their Statements of Investment Principles; and
- have a strategy in place for hedging and mitigating any climate risk identified.

It is concerning that some trustees do not appear to have the skills or resources necessary to undertake these crucial aspects of their duties.

16. In the survey undertaken for our report on climate risk, nearly one-third of respondents felt that the main barrier preventing climate risk being taken into account was a lack of perception on trustee boards that climate risk is a sufficiently high risk factor. 18% of respondents to the survey thought trustee education would help climate risk to be taken more seriously in pension investment decisions. We recently recommended in a response¹⁸

¹⁶ The Economist Intelligence Unit. (2015). *The cost of inaction: Recognising the value at risk from climate change*. Available online at: https://www.eiuperspectives.economist.com/sites/default/files/The%20cost%20of%20inaction_0.pdf [accessed 23 September 2016].

¹⁷ ShareAction and ClientEarth. (September 2016.) *The hot debate on climate risk and pension investments: Does practice stack up against the law?* Available online at: <https://shareaction.org/wp-content/uploads/2016/09/ClimateInvestmentDuties-InvestorReport.pdf> [accessed 9 September 2016].

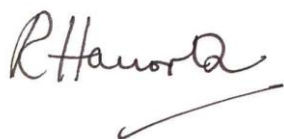
¹⁸ ShareAction. (September 2016.) 'Response to 21st Century Trusteeship and Governance paper'. Available online at: <https://shareaction.org/wp-content/uploads/2016/09/ShareAction-response-to-TPRs-21st-Century-Trusteeship-and-Governance-discussion-paper.pdf> [accessed 23 September 2016].

to the Pensions Regulator's *21st Century Trusteeship and Governance* discussion paper¹⁹ that they (and other relevant regulators) should take steps to educate investment decision-makers on climate risk and other key ESG issues. In particular, this should cover why they should be considered and what steps can be taken to assess and manage the relevant risks. This could include issuing guidance and adding additional sections to the Trustee toolkit on the Pensions Regulator's website.

17. The Pensions Regulator's research found that lack of time was a key barrier to some trustees taking up training. Interviewees in the research conducted for our 2015 report, *Realigning Interests, Reducing Regulation*,²⁰ emphasised that lay trustees need to be given time off by employers for training as well as to attend board meetings. Allowing MNTs time to fulfil their duties needs to be made attractive to employers as, understandably, many may be reluctant to give workers the time off. However, this is not an insurmountable obstacle. We recommended that the Government amends the Employment Rights Act 1996 so that MNTs have the same rights to request reasonable time off work to fulfil their duties as magistrates, school governors, trade unionists, beneficiaries of the Army Reserve forces and other roles prescribed in the legislation.²¹

We would be happy to meet to discuss any of the views raised.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'R Haworth', with a long horizontal flourish underneath.

Rachel Haworth, Policy Officer

¹⁹ The Pensions Regulator. (July 2016.) *21st Century Trusteeship and Governance Discussion paper*. Available online at: <http://www.thepensionsregulator.gov.uk/docs/21st-century-trusteeship-governance-discussion-2016.pdf> [accessed 23 September 2016].

²⁰ de Ste Croix, C. (June 2015.) *Realigning Interests, Reducing Regulation*. Available online at: <http://action.shareaction.org/page/-/ReducingRegulationReport.pdf> [accessed 9 September 2016].

²¹ *Ibid*, p28.